INTERNATIONAL MONETARY FUND

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PORTUGAL

February 2017

FIFTH POST PROGRAM MONITORING DISCUSSIONS—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR PORTUGAL

In the context of the Fifth Post Program Monitoring discussions with Portugal, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 17, 2017 consideration of the staff report that concluded the Fifth PPM discussions with Portugal.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on February 17, 2017, following discussions that ended on December 7, 2016, with the officials of Portugal on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 26, 2017.
- A **Statement by the Executive Director** for Portugal.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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INTERNATIONAL MONETARY FUND

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FOR IMMEDIATE RELEASE
February 22, 2017

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Washington, D. C. 20431 USA

IMF Executive Board Concludes Fifth Post-Program Monitoring with Portugal

On February 17, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Fifth Post-Program Monitoring[1] with Portugal.

After a sluggish first half, the economy experienced a welcome upturn in growth in the second half of 2016, boosted by stronger exports and a further decline in unemployment to pre-crisis levels. These developments point to an improved near-term outlook, but medium-term growth could be put on a more sustainable footing by reducing structural bottlenecks and high levels of corporate debt. The revised 2016 fiscal target appears likely to have been met, but prospective public outlays for banking sector recapitalization continue to weigh on public debt trends.

Executive Board Assessment[2]

Executive Directors welcomed Portugal's improved macroeconomic performance in the second half of 2016, marked by a pick-up in growth, a decline in unemployment, and a fiscal outturn in line with the target. In addition, Portugal has continued to successfully access bond markets and its capacity to repay the Fund is expected to be adequate. Nonetheless, Directors noted that the public debt remains high, and the large annual financing needs, combined with banking system challenges, leave Portugal vulnerable to a range of shocks and a tightening of financing conditions. Directors, therefore, emphasized the need for a stronger momentum to improve financial sector resilience, ensure durable fiscal consolidation, and raise potential growth.

Directors welcomed the recognition by the authorities that continued efforts to improve banking sector soundness are warranted. They stressed that a comprehensive clean-up of bank balance sheets is essential to break the vicious circle between weak banks, high non-performing loans (NPLs), and low growth. This should include a predictable, time-bound, and credible plan for banks to write-off or restructure non-performing legacy assets, strengthen internal governance, and improve bank profitability, including by further cutting costs. This would help attract new private capital to support the clean-up of bank balance sheets. In this context, Directors were

[1] The central objective of PPM is to provide for closer monitoring of the policies of members that have substantial Fund credit outstanding following the expiration of their arrangements. Under PPM, members undertake more frequent formal consultation with the Fund than is the case under surveillance, with a particular focus on macroeconomic and structural policies that have a bearing on external viability.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

encouraged by the authorities' proposals to address NPLs, including supervisory, legal, and judicial measures to incentivize banks to dispose of non-performing loans and reduce corporate debt.

Directors welcomed the authorities' commitment to continued fiscal consolidation and noted their five-pillar strategy. They underscored the importance of a well-specified medium-term fiscal adjustment path that balances the need to put debt on a firmly downward trajectory while supporting growth. They stressed that a fiscal consolidation path that relies more on durable expenditure reform and greater spending efficiency, and less on one-off measures and capital expenditure compression, would be more sustainable and supportive of growth. They also noted the importance of strengthening the budget process.

Directors underscored that reinvigorating macro-critical structural reforms remains essential to boost the economy's competitiveness, growth potential, and resilience to shocks. They encouraged the authorities to proceed with reforms in labor and product markets, with a particular focus on tackling labor market segmentation, improving education and skills, and enhancing public sector efficiency. They noted that it would be important to ensure that increases in the minimum wage do not impair labor competitiveness and undermine prospects for new entrants to the labor force. Removing regulatory barriers, strengthening institutional capacity, and addressing other supply bottlenecks are also considered critical reforms.

Portugal: Selected Economic Indicators

(Year-on-year percent change, unless otherwise indicated)

	2015	2016	Projections 2017	Projections 2018
Real GDP	1.6	1.3	1.3	1.2
Private consumption	2.6	2.0	1.3	1.2
Public consumption	0.8	0.6	0.6	0.3
Gross fixed capital formation	4.5	-1.1	2.8	2.4
Exports	6.1	3.5	3.6	3.9
Imports	8.2	3.2	3.5	3.9
Contribution to growth (Percentage points)				
Total domestic demand	2.6	1.2	1.4	1.3
Foreign balance	-1.0	0.1	0.0	-0.1
Resource utilization				
Employment	1.1	1.4	1.0	0.5
Unemployment rate (Percent)	12.4	11.0	10.6	10.1
Prices				
GDP deflator	2.1	1.6	1.4	1.4
Consumer prices (Harmonized index)	0.5	0.6	1.1	1.4
Money and credit (End of period, percent change)				
Private sector credit	-4.1	-2.2	-0.5	0.1
Broad money	4.6	2.4	2.2	2.1
Fiscal indicators (Percent of GDP)				
General government balance	-4.4	-2.6	-2.1	-2.3
Primary government balance	0.2	1.8	2.2	2.0
Structural primary balance (Percent of potential GDP)	3.3	2.7	2.6	2.3
General government debt	129.0	130.8	129.8	128.7
Current account balance (Percent of GDP)	0.4	0.3	-0.6	-0.7
Nominal GDP (Billions of euros)	179.5	184.7	189.7	194.6

Sources: Bank of Portugal; Ministry of Finance; National Statistics Office (INE); Eurostat; and IMF staff projections.

INTERNATIONAL MONETARY FUND

PORTUGAL

FIFTH POST-PROGRAM MONITORING DISCUSSIONS

January 26, 2017

EXECUTIVE SUMMARY

Portugal has benefited from market financing on relatively favorable terms since the end of their arrangement under the Fund's Extended Fund Facility in 2014. The return to financial markets reflected the successful stabilization of Portugal's economy under the program, and has been supported by the ECB's accommodative monetary stance since early 2015. This has facilitated a steady improvement in the profile of public debt and enabled the authorities to make early repurchases to the Fund of €12.9 billion, more than 40 percent of the amount drawn during the arrangement.

After a sluggish first half, the economy evidenced a welcome upturn in growth in the third quarter of 2016 driven by net exports. Despite the positive quarter, Portugal's medium-term outlook remains impaired by high levels of corporate debt and persistent structural bottlenecks. The revised 2016 fiscal target appears within reach, but prospective public outlays for CGD's recapitalization weighed on public debt at end-2016.

The modest growth outlook, high public and private indebtedness and weaknesses in the banking system are mutually reinforcing. As banks continue to struggle with a large stock of non-performing loans (NPLs), low profitability, and high operating costs, they are unable to provide adequate lending for new investment. Weaker growth, in turn, makes it more difficult for banks to address NPLs and improve profitability, while hampering fiscal consolidation efforts.

Portugal's public debt dynamics remain fragile and leave it vulnerable to a change in financing conditions. While Portugal's capacity to repay the Fund is expected to be adequate under the baseline of a gradual reduction in monetary accommodation, the less benign financing environment accentuates the risk of faster upward pressure on borrowing costs should negative surprises materialize.

Ambitious efforts to improve financial sector resilience, ensure durable fiscal consolidation and raise potential growth are needed to reduce domestic risks. The interlinkages between a modest growth outlook, large annual financing needs, and a challenged banking system leave Portugal vulnerable to a range of shocks that could trigger a change in sentiment and elevate borrowing costs.

Approved By
Mahmood Pradhan and Seán Nolan

Discussions took place in Lisbon during November 29 – December 7, 2016. The staff team comprised S. Lall (head), M. Gaertner, D. Gershenson, A. Santos (all EUR); E. Lundback (SPR); and M. Queyranne (FAD). A. Bouveret (MCM), Y. Cai and V. Bezerra de Menezes (both EUR) supported the mission from headquarters.

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RECENT DEVELOPMENTS AND OUTLOOK

Economic and financial developments have evolved broadly as anticipated in the 2016 Article IV Consultation.[1] The near-term macroeconomic outlook has been slightly upgraded to reflect the strong third-quarter performance on growth and employment. However, medium-term growth is still projected to remain modest at slightly above 1 percent, constrained by corporate debt overhang, sluggish bank lending and persistent structural bottlenecks.

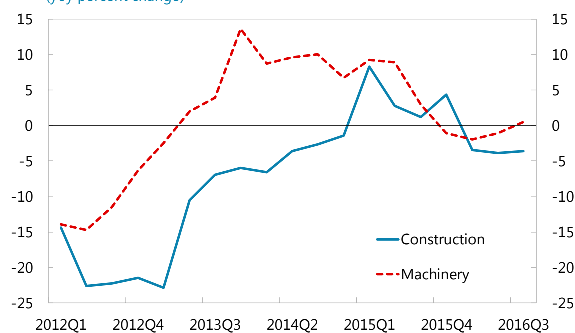
1. **Recent economic developments point to a slightly improved near-term outlook but a continuation of modest growth over the medium-term.** Real GDP growth accelerated to 1.6 percent (year-on-year) in the third quarter, up from 0.9 percent in the first half of 2016. Output growth continues to be fueled by strong growth in private consumption, but the pickup in Q3 also benefited from an improvement in net exports, reflecting in part the strong tourist season. Labor market outturns have also been better-than-expected, with the unemployment rate falling to the pre-crisis level of 10.5 percent, while investment showed tentative signs of a recovery after a deceleration in the preceding quarters.

Contributions to year-on-year growth, 2016
(percentage points, unless indicated otherwise)

	Q2	Q3
Total domestic demand	**0.8**	**1.0**
Final consumption expenditure	1.2	1.4
Public	0.1	0.1
Private	1.0	1.3
Gross fixed capital formation	-0.4	-0.1
Changes in inventories	0.0	-0.3
Foreign balance	**0.1**	**0.7**
Exports GS	0.8	2.3
Imports GS	-0.7	-1.6
Real GDP growth, percent	**0.9**	**1.6**

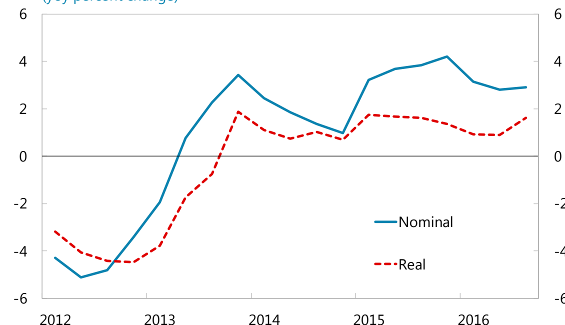
Source: Haver Analytics.

Real Gross Fixed Capital Formation
(yoy percent change)



Sources: Haver Analytics; and IMF staff calculations.

Gross Domestic Product
(yoy percent change)



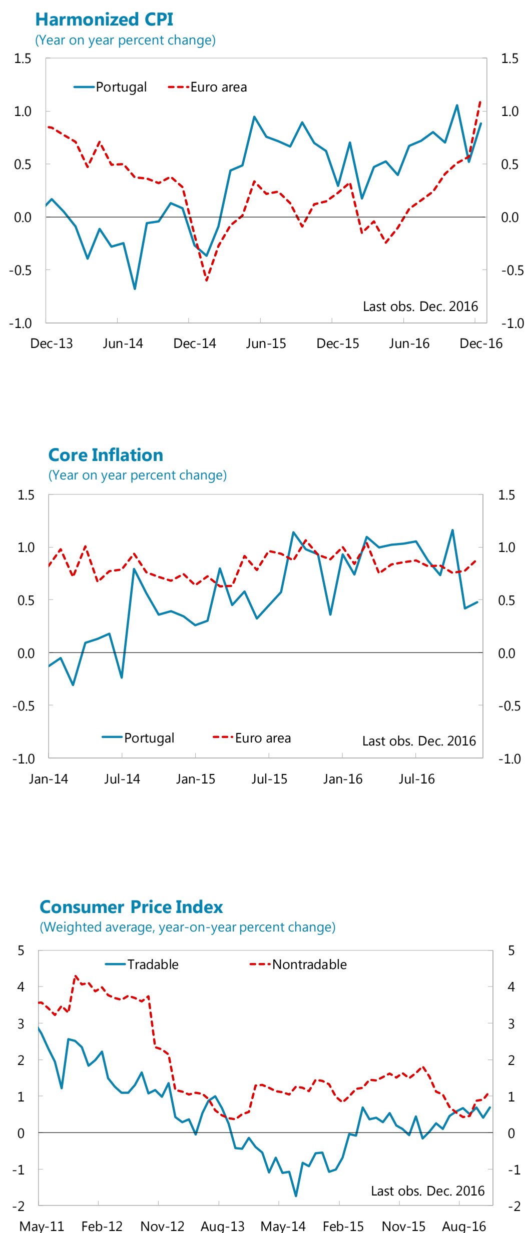
Sources: Haver Analytics; and IMF staff calculations.

[1] See EBS/16/76, Portugal—Staff Report for the 2016 Article IV Consultation and Fourth Post-Program Monitoring Discussions.

2. Headline inflation remains relatively low (between 0.5 and 1 percent year-on-year), but competitiveness has not improved. Core inflation has been on a slow upswing over the past two years, and nontradables inflation has been generally above that of tradables, with the ratio of non-tradable to tradable prices staying elevated. While the ULC-based real effective exchange rate is substantially below past peaks, the improvement has stalled in the past year, with some modest appreciation since mid-2015.

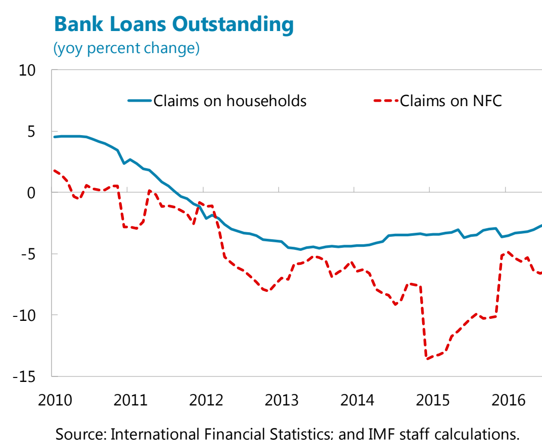
3. The current account remained in a small surplus in 2016 as a deterioration in the income balance was offset by continued growth in tourism revenues. The overall surplus was unchanged during January-October from a year before, as income paid to non-residents increased, while tourism revenues rose more than 10 percent (year-on-year), on pace for the third consecutive year of double-digit growth. The increase in exports of goods has slowed, however, with non-fuel exports rising only 1.8 percent during January-November (year-on-year) compared with 4.6 percent in 2015.

Figure 1: Consumer Price Inflation



Sources: Haver Analytics; INE; and IMF staff calculations.

4. Bank lending remains subdued, particularly to the corporate sector, contributing to weak investment and constraining the growth outlook. Credit outstanding to the private sector fell 4 percent in the twelve months through November, with the decline particularly pronounced for corporate credit, which fell 5 percent. New lending remains concentrated primarily in consumer loans, which have risen steadily since September 2015. The low volume of new lending appears to reflect both banks' risk aversion due to their continued weak asset quality as well as weak demand for credit from overleveraged corporates.



Source: International Financial Statistics; and IMF staff calculations.

Staff views

5. Near-term risks to the macroeconomic outlook are broadly balanced. The strong 2016Q3 growth outturn was welcome following weak growth in the first half of the year, with positive signs from a pickup in employment and modest recovery in investment. The tourism sector has remained a bright spot, but other exports remain subdued, with a moderate outlook for growth in Portugal's main trading partners. Against this background, staff has raised real GDP growth projections for 2016 and 2017 slightly to 1.3 percent. Risks are broadly balanced around this baseline, as investment and exports could surprise on the upside, while tighter-than-expected financing conditions could drive consumption down. In the medium-term, the corporate debt overhang and subdued bank lending are likely to remain a drag on investment, while the very low household savings rate limits scope for consumption to continue to drive growth. As a result, the medium-term growth projection remains unchanged at around 1.2 percent.

Authorities' views

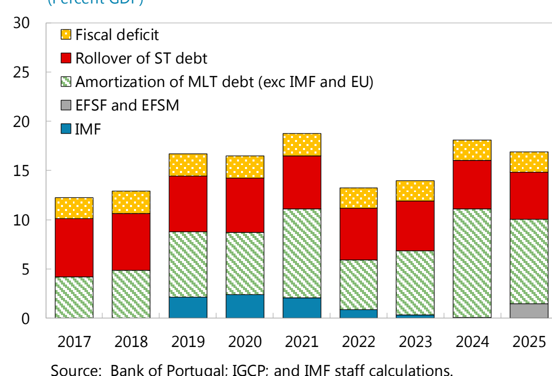
6. The authorities were confident that the output acceleration in 2016Q3 is indicative of a sustained shift to a higher growth path. They considered the subdued first-half outturn to be heavily influenced by one-off factors that had reversed in the second half of the year, and viewed indications of a pick-up in investment as reflecting renewed confidence over Portugal's growth prospects. The authorities noted that the pickup in growth provided further justification for the macroeconomic assumptions that underpin the 2017 budget— growth of 1.2 percent in 2016 and 1.5 percent in 2017—and considered risks to the outlook as emanating primarily from external factors.

CAPACITY TO REPAY THE FUND

Portugal's capacity to repay the Fund is expected to be adequate, but fragile public debt dynamics leave it exposed to a multiplicity of self-reinforcing medium-term risks, as outlined in the 2016 Article IV.[2] The interlinkages between a modest growth outlook, high public debt, and a struggling banking system leave Portugal vulnerable to a range of shocks. The country has been able to borrow on relatively favorable terms in recent years, bolstered by the ECB's sovereign debt purchases under the Public Sector Purchase Program (PSPP), but the realization of downside risks in any of these areas could trigger a sudden change in sentiment and a potential tightening in access to financing.

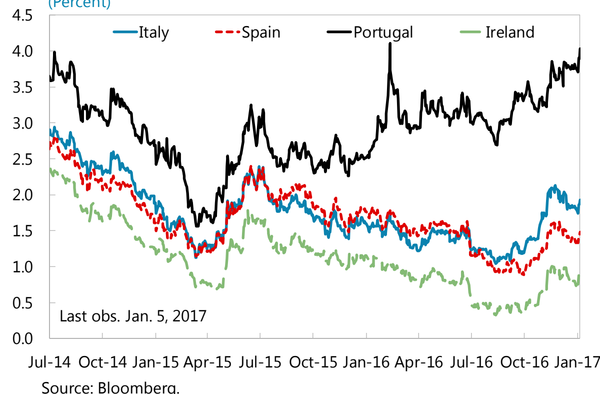
7. Portugal has benefited from access to market financing on relatively favorable terms over the past two years, allowing a steady improvement in the profile of public debt. Portugal made €4.5 billion in advanced repurchases to the Fund in 2016, for a total of €12.9 billion since the end of the program; the next scheduled repurchase is not until April 2019. While annual financing needs remain large, a combination of longer-term issuance and shorter-term debt buybacks has helped to moderate near-term refinancing needs and smooth the redemption profile of public debt over the past two years.[3] This slowed in 2016 as the authorities increased their issuance in the domestic retail market to help diversify their investor base and limit overall borrowing costs, but the average maturity of non-IMF/EU debt has improved to 6.6 years at end-2016 compared to 5.1 years at end-2013. The authorities also retained a cash buffer of €10.2 billion at end-2016, sufficient to cover about 50 percent of next year's projected financing need (excluding short-term rollover).[4]

Portugal: General Government Gross Financing Need
(Percent GDP)



Source: Bank of Portugal; IGCP; and IMF staff calculations.

10 Year Government Bond Yields
(Percent)



Source: Bloomberg.

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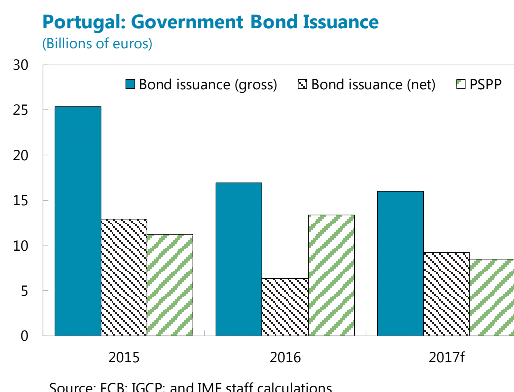
[2] See EBS/16/76, Portugal–Staff Report for the 2016 Article IV Consultation and Fourth Post-Program Monitoring Discussions.

[3] The longer average maturity of public debt and smoother redemption profile has increased resilience to a rise in borrowing costs. The stress test in the Public DSA (Annex I) shows that a sustained interest rate shock of 280 basis points would increase the debt to GDP ratio by 3 percentage points relative to the baseline by 2021.

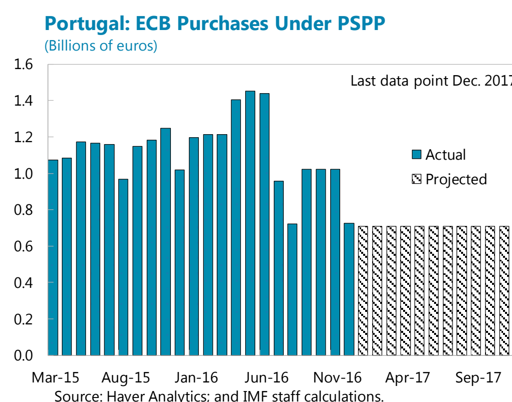
[4] This also incorporates the state's expected contribution for the recapitalization of CGD. The authorities maintain an indicative target for the cash buffer of 40-50 percent of the projected financing need for the next twelve months (excluding short-term rollover).

8. However, the terms of Portugal's market access appear to be significantly influenced by the support to the sovereign debt market provided by the ECB's PSPP. ECB sovereign debt purchases on the secondary market were equal to the full amount of Portugal's net bond issuance during 2015, and were more than double net issuance during 2016. As of end-2016, the ECB's holdings of Portuguese sovereign bonds had increased to nearly one-third of the total outstanding. Sovereign spreads have risen despite the sizable support from PSPP, however, with spreads on 10-year Portuguese bonds vis-à-vis German bunds at nearly 370 basis points in early 2017 and spreads vis-à-vis other southern European economies continuing to widen in late 2016 and early 2017.



Source: ECB; IGCP; and IMF staff calculations.

9. The ECB's monetary policy announcement on December 8 implies a reduction in average monthly purchases of Portuguese debt through PSPP. The program was extended to the end of 2017, with the minimum eligibility maturity lowered from 2 to 1 year, but the issuer limit of 33 percent was not increased.[5] For Portugal, this implies a reduction in monthly purchases by the ECB of roughly 40 percent or more from 2016.[6] Bond yields rose sharply on the announcement, with the benchmark ten-year yield now near 4 percent, compared to 3.5 percent at the time of Portugal's exit from the EFF in May 2014. A syndicated 10-year issuance was placed in mid-January at a yield of 4.2 percent.



Source: Haver Analytics; and IMF staff calculations.

Staff views

10. The gradual tightening of the financing environment, in the context of downside vulnerabilities, increases the risks to Portugal's medium-term capacity to repay the Fund. While Portugal's capacity to repay is expected to be adequate under the baseline of a gradual reduction in monetary accommodation, a less benign financing environment increases the vulnerability to sudden fluctuations in market conditions. The baseline remains vulnerable to

[5] Portugal's eligibility for PSPP depends on maintaining an investment grade credit rating from DBRS, the only ratings agency to currently do so. DBRS affirmed Portugal's rating on October 21, but cited concern about the impact of the weak growth outlook on debt dynamics. DBRS also noted that rising yields could pose a risk to the outlook.

[6] In accordance with PSPP operational rules, monthly purchases are expected to be reduced in order to remain within the issuer limit and maintain a relatively consistent profile until the end of the program.

negative surprises, such as a deterioration in the macroeconomic outlook or external risks—including from US yield curve steepening, rising global bond yields, or a hard landing in China—which could all push spreads significantly higher than projected. A negative surprise emanating from the banking system could be particularly damaging. While the improved structure of public debt has strengthened Portugal's resilience to higher borrowing costs, sharply rising yields could quickly create a reinforcing cycle where market financing becomes more restrictive, in turn driving yields higher.

Authorities' views

11. The authorities were confident that recent macroeconomic developments would support continued favorable access to financing. They noted that Portuguese government bond issuance had been conducted as planned in 2016 despite volatility at times throughout the year, and expected that recent macroeconomic and fiscal developments, together with steps to shore up the domestic banking system, would have a positive impact on investor confidence. The authorities did not see significant domestic risks, but acknowledged that external shocks (including those presented in the RAM Annex II) could trigger a sudden change in financing conditions. With longer-term bond yields now approaching 4 percent, the authorities acknowledged that the prospective interest savings from further Fund prepayments is declining, but noted that negative deposit rates have also increased the cost of retaining a large cash buffer.

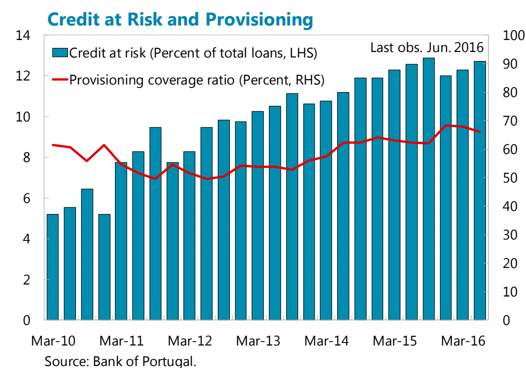
POLICY DISCUSSIONS

Reducing vulnerabilities created by the struggling banking system and high public debt will remain challenging. The authorities appear to be moving toward a more comprehensive approach to addressing the high level of NPLs, but plans to attract new capital into the banking system have yet to be completed. The 2016 fiscal target looks likely to be achieved, but outlays for banking sector recapitalization continued to weigh on public debt dynamics, while there has been little movement on key structural reforms.

A. Financial Sector

12. As discussed in the 2016 Article IV, the Portuguese banking system remains liquid but continues to struggle with low asset quality, low profitability, and limited capital buffers. The authorities estimated the outstanding stock of NPLs at €49 billion at end-2015 (27 percent of GDP), accounting for both overdue and unlikely-to-pay loans and representing 19 percent of total loans.[7] Credit at risk[8] rose to 12.6 percent of gross loans in 2016Q3,

Credit at Risk and Provisioning



Source: Bank of Portugal.

[7] As per the 2016 ECB guidance on non-performing loans. See Bank of Portugal, Relatorio de Estabilidade Financeira, November 2016, Chapter IV for further discussion.

[8] Credit at risk is a narrower national definition that includes overdue loans and restructured loans with weaker guarantees and unpaid principal and/or interest.

meanwhile, up from 12 percent at end-2015. The weakness in asset quality remains particularly concentrated in the corporate sector, with corporate credit at risk at 20.2 percent in 2016Q3, compared with credit at risk of 6 percent on household loans for house purchase. Despite a reduction in risk-weighted assets and associated capital requirements, Portugal has the second lowest CET1 ratio in the EU at 12.3 percent of risk-weighted assets as of 2016Q3 (based on EBA data).

13. Total capital in the banking system above the regulatory requirements appears insufficient to tackle the likely capital shortfall in the system if NPLs are fully provisioned for. Banks have increased loan loss impairments and reduced operational costs, showing greater willingness to recognize losses on bad loans and increase buffers to absorb them, but cost-cutting measures have not offset the drag on profitability from low interest margins and weak asset quality. While capital ratios remain above regulatory minima, aggregate capitalization would come under pressure if earnings are insufficient to absorb additional provisions associated with the total stock of NPLs.

14. To offset the effects of additional losses on bad loans, individual banks have pursued different strategies. In August, the authorities announced a preliminary agreement with the EC on a €5 billion recapitalization of CGD. The plan includes a public sector contribution of €2.7 billion and a new subordinated debt issue of €0.5 billion, as well as a series of cost-cutting measures and improved corporate-governance rules.[9] An asset impairment review to determine the bank's exact recapitalization need and market test are still to be conducted; the process is expected to be completed in the first quarter of 2017[10]. Meanwhile, negotiations to sell Novo Banco, which would transfer control to a new shareholder with new capital, remain ongoing.[11] A private capital injection in BCP—with commitments by largest shareholders to increase their holdings by up to 30 percent of total shares—has received shareholder and regulatory approvals, and BPI's takeover by CaixaBank has also received regulatory approval.

Staff views

15. As discussed in previous staff reports, a comprehensive balance sheet clean-up is essential to break the vicious circle between weak banks, high NPLs, and low growth. This should include a predictable, time-bound and credible plan for efforts across banks to write-off or restructure non-performing legacy assets, strengthen internal governance, and improve bank profitability, including by further cutting costs. Supervisors should ensure that banks set up ambitious targets for NPL reduction and incentivize banks to move NPLs off of their balance sheet by forcing them to increase their coverage ratios, especially by setting aside additional provisions for unlikely-to-pay loans that could be reported as non-distributable capital reserves. Finally, a more

[9] While the plan will still need formal EC approval, the EC has indicated that the subordinated debt issue and bank restructuring plan would make the operation sufficiently market-based to avoid classification as state aid.

[10] The process was delayed in part by a change in the CEO and most of the Board in late 2016.

[11] The terms of a possible Novo Banco sale remain to be clarified, with press reports suggesting that current offers may require additional government support and/or regulatory approval.

proactive approach by banks would also need to incorporate a stepped-up focus on profitability, underpinned by additional cost reductions and increases in efficiency.

16. The predictability that such a comprehensive strategy across the banking system would engender is necessary to attract new private capital to support the clean-up of balance sheets. The high level of public debt leaves no fiscal space to allow public financing for a 'bad bank', making it essential that banks are able to raise additional private capital. A comprehensive approach including fundamental changes in the internal governance structure of banks would remove the uncertainty surrounding the treatment of legacy nonperforming assets and the criteria used for future lending, allowing potential investors to realistically assess the expected return on their capital. It is doubtful that sufficient private investment would be forthcoming without a credible and ambitious effort by banks, given the difficulty in assessing the value of assets and enforcing creditor claims over a predictable timeframe.

Authorities' views

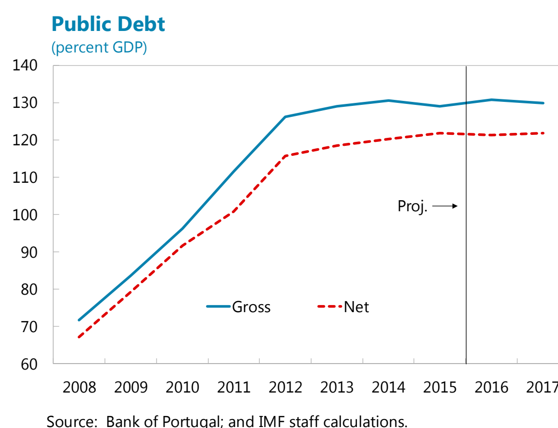
17. The authorities are considering a more systemic approach to dealing with legacy assets. They are considering proposals to address legacy assets, including supervisory, legal and judicial measures to incentivize banks to dispose non-performing loans, aim at not only strengthening banks' balance sheets but also reducing the high debt levels in the nonfinancial corporate sector, with further positive effects on its equity, investment, employment, and growth. However, the authorities noted that, even though banks have deleveraged and reduced associated operational costs, they need to continue to increase profitability, improve corporate governance, and invest in innovations. The authorities emphasized that the stock of NPLs in the banking system is fully accounted for in their latest estimates following an updated stocktaking exercise.

18. The authorities noted that, even though banks are liquid, they are more cautious in their lending decisions. Overall, banks have improved their risk management and control. As a result of higher underwriting standards, banks have been providing credit mainly to low-risk borrowers, even at lower credit spreads. Credit demand is also constrained by the high debt levels in the nonfinancial corporate sector.

B. Fiscal Policy

19. The revised 2016 fiscal deficit target of 2.5 percent of GDP agreed with the European Commission appears within reach, with a further reduction to 1.6 percent of GDP planned in 2017. A sizable revenue shortfall and higher-than-planned spending on public wages in 2016 looks likely to have been offset by a large under-execution of budgeted intermediate consumption and public investment. The 2017 budget will continue to unwind measures introduced during the program, including the full removal of the personal income tax surcharge and an unfreezing of pension indexation, at a total cost of 0.2 percent of GDP. This would be primarily offset by hikes in property taxes and indirect taxes, as well as projected increases in non-tax revenues and recovery of outstanding tax debt.

20. The prospective reduction in public debt by the end of 2017 is expected to be modest, however, reflecting the impact of the recapitalization of CGD. The public sector cash contribution under the current plan will amount to 1.5 percent of GDP, while the conversion of the state's contingent convertible bonds and the transfer of the state's equity stake in a CGD subsidiary will equal an additional 0.8 percent of GDP.[12] As a result, public debt rose to an all-time high of close to 131 percent of GDP at end 2016, with only a modest decline to around 130 percent projected for end-2017.



Source: Bank of Portugal; and IMF staff calculations.

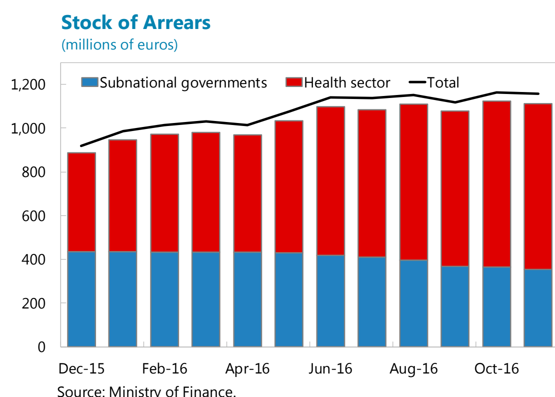
Staff views

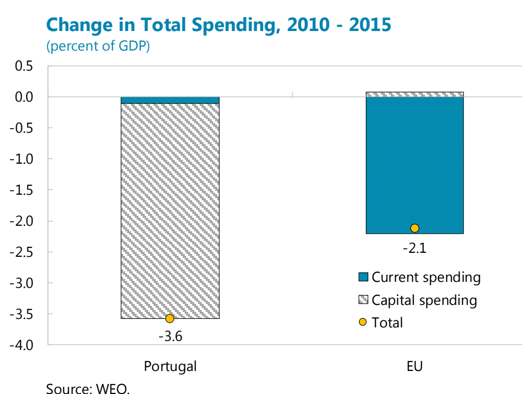
21. The 2017 budget depends in large part on optimistic revenue projections, raising risks to execution. Spending containment appears to be based primarily on untargeted measures and mid-year adjustments to budget allocations rather than durable reforms to reduce overlap and improve the efficiency of public spending. The planned reduction in the deficit also relies heavily on one-off revenues from the repayment of a state guarantee called in 2010 (0.2 percent of GDP) and an increase in dividend payments from the central bank (0.2 percent of GDP). On the basis of the approved measures, staff projects a fiscal deficit of 2.1 percent of GDP next year, an implied structural primary loosening of 0.1 percent of GDP (compared with the Article IV recommendation of a tightening of 0.6 percent).

22. The compression of capital spending to meet budget targets could have a detrimental effect on output. Public investment was significantly lower than the average in the EU over the last

[12] The statistical treatment of this transaction remains unclear. There appears a high likelihood that Eurostat will count at least part of the operation as expenditure, to reflect the large losses recorded by CGD in recent years. Pending a ruling by Eurostat, the operation is included as a non-deficit increasing financial transaction in staff's projections for 2017, with an impact on public debt but not the fiscal deficit. Public debt will not be affected by the equity transfer.

five years, and is likely to fall further behind as a result of spending containment in 2016. The negative impact of sustained low public investment on potential output is expected to be tangible, exacerbating the long-term decline in private investment experienced since the financial crisis. In addition, there was an increase in arrears in January-November 2016, particularly in hospitals, which adversely impacts private providers and is likely to increase spending pressures in 2017. While a shift from direct to indirect taxation should in principle be more supportive of growth, frequent changes in the tax regime risk an adverse impact on investment.





Authorities' views

23. The authorities were confident that their targets for 2016-17 would be met, underpinned by the prospect of additional revenue from recovery of outstanding tax debt. They emphasized the success of their efforts to control spending in 2016 by freezing part of line ministries' budget allocations, and planned to continue this approach in 2017, supported by savings from the ongoing spending review. The authorities also highlighted the positive response to their tax recovery scheme announced in late 2016, and were confident that additional revenues under this program would be more than sufficient to offset any spending pressures and would also help to reduce arrears that have accumulated in the health sector. The authorities' also cited concerns with the estimates of potential growth used to calculate the underlying structural adjustment, which they felt understated fiscal consolidation efforts in 2016-17.

C. Structural Reforms

24. Implementation of macro-critical reforms has largely stalled over the past year, exacerbating the drag on potential growth from low investment and a shrinking labor force. The IMF staff's survey of firms in the context of the 2015 Article IV consultation suggested that key areas for further reforms included the effectiveness of public administration and the judicial system, the payments discipline of public sector entities, and the insolvency and corporate debt restructuring frameworks. Consistent with these findings, Portugal's assessment in the World Economic Forum's 2016-17 Global Competitiveness Report (GCR)[13] underscores the remaining structural gaps, emphasizing deficiencies in labor market flexibility and the efficiency of the judicial system and the public administration.

[13] Portugal fell from 38th to 46th out of 138 countries included in the report.

25. The authorities' structural agenda focuses on improving the comparatively low skill level of the Portuguese labor force and fostering greater innovation. The National Reform Program for 2016-2020 includes several key components: (i) Development of human capital, through better formal education, lifelong learning and improvements in managerial skills; (ii) Recapitalization of the corporate sector, by developing instruments to diversify financing sources, including incentives to increase equity and reduce reliance on bank financing; (iii) Modernization of the public sector, including simplification of administrative and licensing procedures for enterprises; and (iv) Encouraging R&D, innovation and entrepreneurship. The authorities have also approved a further 5 percent increase in the minimum wage from 2017, above the growth in labor productivity. This follows increases of 4 percent in October 2014 and 5 percent in January 2016, implying a cumulative real increase of around 13 percent since mid-2014.

Staff views

26. A reinvigoration of the structural reform agenda is essential to improve growth prospects, and support fiscal consolidation efforts. The authorities' agenda includes several welcome initiatives, but staff would advise an emphasis on key reforms more closely aligned with macro-critical structural gaps impacting labor market and export competitiveness.[14] Linking minimum wage increases to productivity is essential to maintaining competitiveness, especially since the ratio of minimum to median wages in Portugal continues to be well above the euro area average. The authorities should also take steps to bridge the gap between temporary and permanent contracts; the gradualist approach thus far has left the needed labor market flexibility to be largely borne by newer entrants to the labor market working on temporary contracts with fewer benefits. An appropriately inclusive social dialogue is also key to the success of structural reforms, based on engaging all stakeholders—including the unemployed, the broader labor force, and a wider cross-section of employers—in an open and transparent debate about the relative merits of reforms.

Authorities' views

27. The authorities emphasized their commitment to carry forward the structural reforms implemented during the program. In particular, they noted concerns about labor market segmentation and emphasized that any changes would not constitute a change in the direction of reforms, but were intended to address social inequities that had emerged from the erosion of labor protection following the financial crisis. They noted staff's concern on the composition of labor market adjustment in recent years, but were reluctant to adjust existing rights under permanent contracts.

[14] In line with the recommendations of the October 2015 Staff paper ("Structural Reforms and Macroeconomic Performance: Initial Considerations for the Fund").

STAFF APPRAISAL

28. Portugal's economy experienced a welcome pick-up in activity in the third quarter of 2016. This followed a subdued first half of the year. As a result, growth projections for 2016-17 have been upgraded slightly, and near-term risks to the macroeconomic outlook are broadly balanced. Nevertheless, high debt and structural bottlenecks are likely to remain a drag on medium term prospects. The medium-term growth outlook remains little changed from the 2016 Article IV Consultation, with the consumption-based recovery of the past three years likely to run out of steam due to depleted household savings, while poor asset quality in the banking system continues to limit access to financing for new investment.

29. Portugal's public debt dynamics remain fragile and leave it vulnerable to a change in financing conditions. The interlinkages between a modest macroeconomic outlook, large annual financing needs, and a struggling banking system leave Portugal vulnerable to a range of shocks that could trigger a sudden change in sentiment and disrupt access to financing. In order to reduce vulnerabilities, Portugal needs to unwind these self-reinforcing interlinkages by aggressively addressing NPLs and attracting new bank capital, advancing fiscal consolidation and reinvigorating the structural reform agenda.

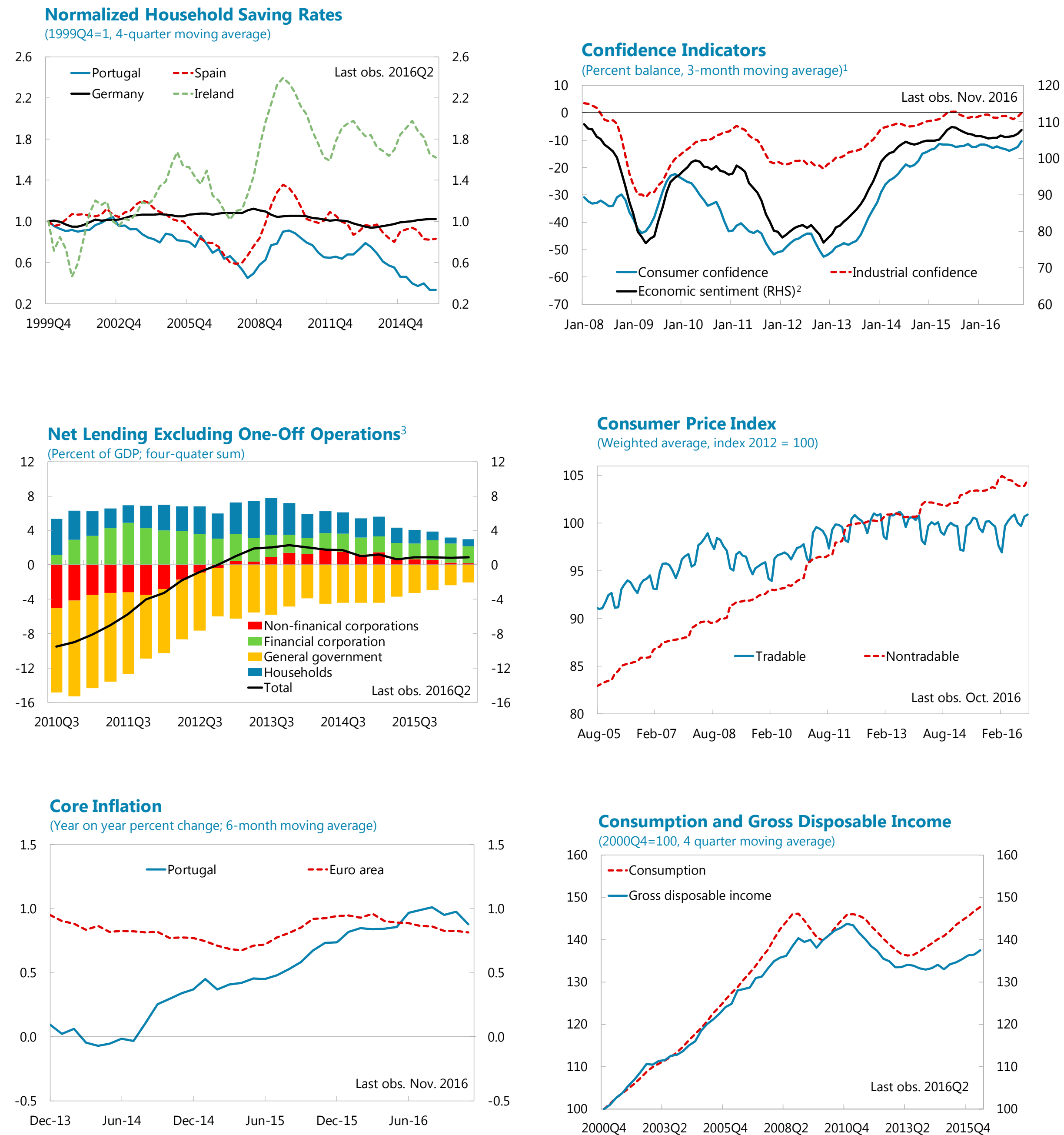
30. Portugal has continued to enjoy market access at relatively low but rising yields. In an environment of ample liquidity, the sovereign has been able to access both international and domestic markets to meet its financing requirements regularly during the course of 2016. The financing environment is likely to become somewhat less benign as expectations of gradual monetary policy normalization in the euro area begin to be priced in. While Portugal's capacity to repay the Fund is expected to be adequate under the baseline of a gradual reduction in the extent of monetary accommodation, there are tangible risks of faster upward pressure on Portugal's borrowing costs should any negative surprises materialize, underscoring the need to reduce domestic sources of risk.

31. A comprehensive clean-up of bank balance sheets is essential to break the vicious circle between weak banks, high NPLs, and low growth. This should include a predictable, time-bound and credible plan for efforts across banks to write-off or restructure non-performing legacy assets, strengthen internal governance, and improve bank profitability, including by further cutting costs. The predictability that such a comprehensive strategy across the banking system would help foster is essential to attract new private capital in order to allow banks to absorb the required impairments.

32. A fiscal consolidation based on durable expenditure reform would be more sustainable and supportive of growth. The revised 2016 fiscal target of a 2.5 percent of GDP deficit agreed with the European Commission appears within reach, thanks to a large under-execution of budgeted intermediate consumption and public investment. The 2017 budget targets a further reduction in the deficit to 1.6 percent of GDP, but spending implementation will again rely on freezing budget allocations rather than durable measures to reform the structure of public spending. The budget also appears to depend on optimistic revenue assumptions; staff projects a 2017 fiscal deficit on the order of 2.1 percent of GDP.

33. Greater efforts to push forward with structural reforms are needed to boost the economy's growth potential. As a member of a currency union with limited fiscal space, it is essential that labor markets have sufficient flexibility for adjustment. Full implementation of the already-enacted reforms in labor and product markets must be complemented by additional steps to promote growth and competitiveness, with a particular focus on streamlining the functioning of the public sector. A further increase in the minimum wage risks undermining labor competitiveness, while labor market adjustment continues to be largely borne by newer entrants to the labor force on temporary contracts.

Figure 2. Portugal: Real Sector Indicators



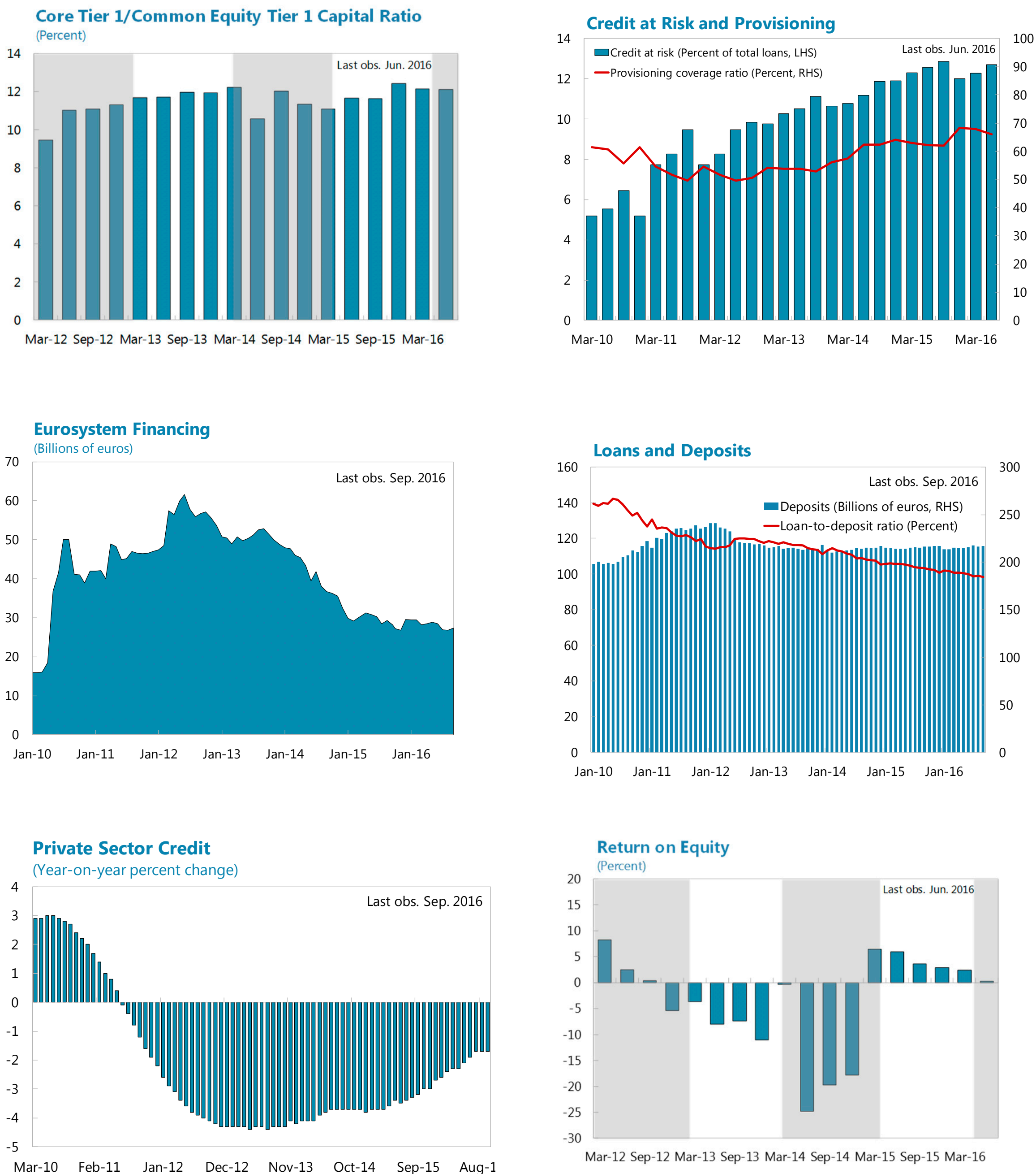
Sources: Haver Analytics; IMF staff calculations; European Commission business and economic surveys; Statistics Portugal.

[1]Percent balance equals percent of respondents reporting an increase minus the percent of respondents reporting a decrease.

[2]Long-term average = 100.

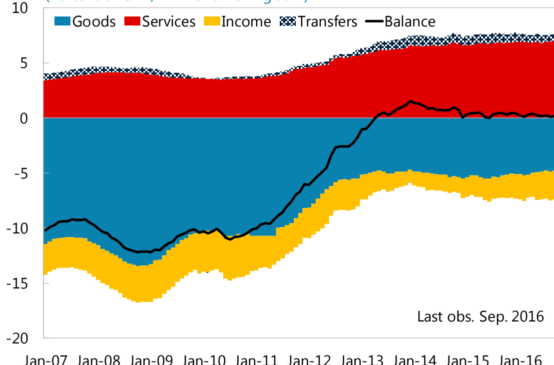
[3] Excludes the recapitalization of Novo Banco (2014) and the Banif resolution (2015).

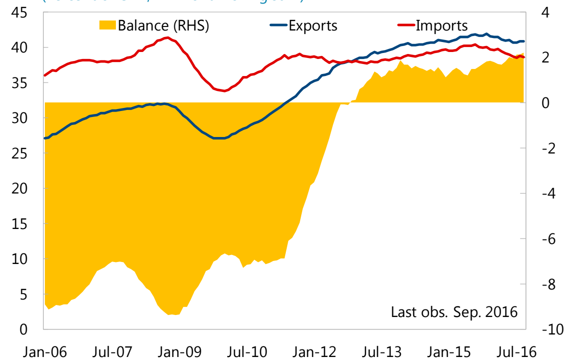
Figure 3. Portugal: Financial Sector Indicators

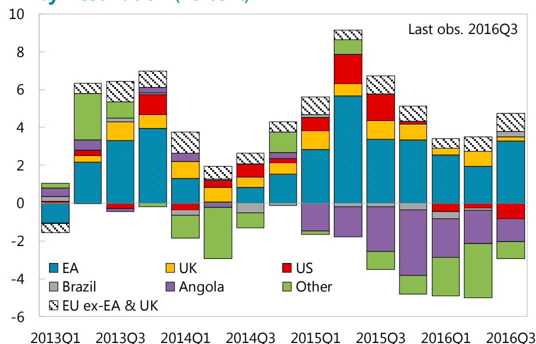


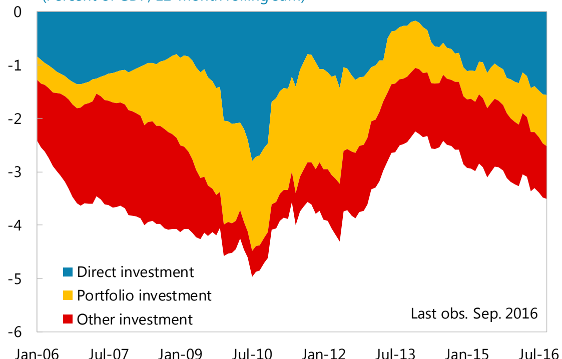
Sources: Haver Analytics; Bank of Portugal; and IMF staff calculations.

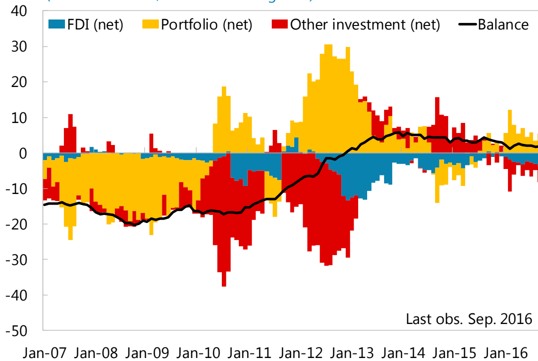
Figure 4. Portugal: External Sector Indicators

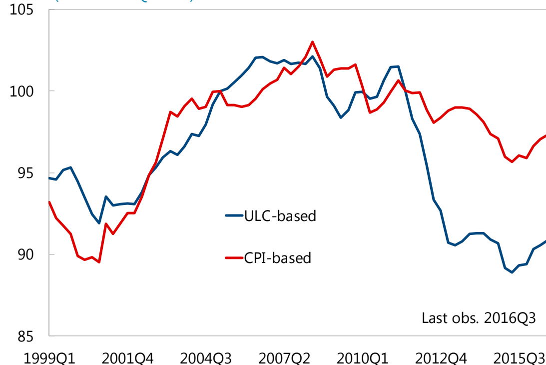












Sources: Haver Analytics; Bank of Portugal; and IMF staff calculations.

Table 1. Portugal: Selected Economic Indicators, 2013-2021
(Year-on-year percent change, unless otherwise indicated)

				Est.		Projections				
	2013	2014	2015	2016		2017	2018	2019	2020	2021
				4th PPM	5th PPM					
Real GDP	-1.1	0.9	1.6	1.0	1.3	1.3	1.2	1.2	1.1	1.0
Total domestic demand	-2.0	2.2	2.5	1.2	1.2	1.4	1.3	1.2	1.1	1.0
Private consumption	-1.2	2.3	2.6	2.2	2.0	1.3	1.2	1.1	1.0	0.9
Public consumption	-2.0	-0.5	0.8	0.3	0.6	0.6	0.3	0.2	0.2	0.2
Gross fixed investment	-5.1	2.3	4.5	-1.2	-1.1	2.8	2.4	2.4	2.4	2.4
Private	-3.3	2.9	1.9	-0.6	1.0	2.9	2.6	2.6	2.6	2.6
Government	-14.3	-1.3	21.2	-4.4	-12.6	2.2	1.2	1.2	1.1	1.0
Exports	7.0	4.3	6.1	2.9	3.5	3.6	3.9	4.0	3.9	4.0
Imports	4.7	7.8	8.2	3.2	3.2	3.5	3.9	3.9	3.9	3.9
Contribution to Growth										
Total domestic demand	-2.0	2.2	2.6	1.3	1.2	1.4	1.3	1.2	1.1	1.0
Private consumption	-0.8	1.5	1.7	1.4	1.3	0.9	0.8	0.8	0.7	0.6
Public consumption	-0.4	-0.1	0.2	0.1	0.1	0.1	0.1	0.0	0.0	0.0
Gross fixed investment	-0.8	0.4	0.7	-0.2	-0.2	0.4	0.4	0.4	0.4	0.4
Foreign balance	0.8	-1.4	-1.0	-0.2	0.1	0.0	-0.1	-0.1	-0.1	-0.1
Savings-investment balance (Percent of GDP)										
Gross national savings	15.3	15.4	15.9	14.8	15.5	15.4	15.6	15.9	16.2	16.6
Private	18.1	20.5	17.8	15.7	16.1	15.5	15.9	16.1	16.5	16.9
Public	-2.8	-5.1	-2.0	-1.0	-0.6	-0.1	-0.3	-0.2	-0.3	-0.3
Gross domestic investment	14.6	15.3	15.5	14.7	15.2	15.9	16.3	16.7	17.3	17.9
Private	12.6	13.2	13.0	12.7	13.2	13.9	14.2	14.7	15.2	15.8
Public	2.1	2.1	2.4	2.0	2.0	2.0	2.0	2.1	2.1	2.1
Resource utilization										
Potential GDP	-0.3	-0.3	0.0	0.2	0.2	0.2	0.4	0.5	0.7	1.0
Output Gap (Percent of potential)	-6.2	-5.1	-3.6	-2.9	-2.5	-1.4	-0.6	0.0	0.4	0.3
Employment	-2.6	1.6	1.1	0.8	1.4	1.0	0.5	0.5	0.5	0.5
Unemployment rate (Percent)	16.2	13.9	12.4	11.8	11.0	10.6	10.1	9.7	9.2	8.8
Prices										
GDP deflator	2.3	0.8	2.1	1.7	1.6	1.4	1.4	1.5	1.7	1.7
Consumer prices (Harmonized index)	0.4	-0.2	0.5	0.7	0.6	1.1	1.4	1.5	1.6	1.8
Compensation per worker (Whole economy)	1.3	0.3	2.4	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Labor productivity	1.6	-0.6	0.4	0.2	-0.1	0.3	0.7	0.7	0.6	0.5
Unit labor costs (Whole economy)	1.8	-1.2	-0.4	1.3	1.7	1.2	0.8	0.8	0.9	1.0
Money and credit (End of period, percent change)										
Private sector credit	-5.2	-8.0	-4.1	-2.2	-2.2	-0.5	0.1	0.8	1.6	1.6
Broad money	0.2	-0.9	4.6	2.3	2.4	2.2	2.1	2.2	2.2	2.2
Interest rates (Average, percent)										
Short-term deposit rate	2.1 .	1.6	0.8	...	...	...	...	...	...	...
Government bond rate, 10-year	6.3 .	3.8	2.4	...	3.2	...	...	...	...	...
Fiscal indicators (Percent of GDP)										
General government balance	-4.8	-7.2	-4.4	-3.0	-2.6	-2.1	-2.3	-2.2	-2.2	-2.3
Revenues	45.1	44.6	44.0	43.7	43.2	43.7	43.2	43.0	42.7	42.6
Expenditures	49.9	51.8	48.4	46.6	45.8	45.7	45.5	45.2	45.0	44.9
Primary government balance	0.0	-2.3	0.2	1.6	1.8	2.2	2.0	2.0	1.9	1.9
General government debt	129.0	130.6	129.0	128.3	130.8	129.8	128.7	127.2	126.2	125.3
External sector (Percent of GDP)										
Trade balance (Goods)	-4.7	-5.5	-5.1	-5.3	-5.1	-5.9	-6.3	-6.8	-7.3	-7.7
Trade balance (Goods and Services)	1.9	1.1	1.8	1.8	2.1	1.3	1.1	0.8	0.6	0.2
Current account balance	1.5	0.1	0.4	0.0	0.3	-0.6	-0.7	-0.9	-1.1	-1.4
Net international investment position	-116.3	-114.9	-109.3	-105.2	-105.1	-101.7	-98.7	-96.0	-93.5	-91.4
REER based on ULC (1999=100)	102.9	103.3	102.6	102.8	104.5	104.5	104.4	104.3	104.6	104.5
(Rate of growth)	1.7	0.4	-0.7	1.8	1.8	0.0	-0.1	0.0	0.2	-0.1
REER based on CPI (1999=100)	107.4	106.2	103.4	107.1	104.7	104.6	104.6	104.5	104.5	104.6
(Rate of growth)	0.1	-1.2	-2.6	0.7	1.2	-0.1	0.0	0.0	0.0	0.1
Nominal GDP (Billions of euros)	170.3	173.1	179.5	184.4	184.7	189.7	194.6	199.9	205.4	210.9

Sources: Bank of Portugal; Ministry of Finance; National Statistics Office (INE); Eurostat; and IMF staff projections.

Table 2a. General Government Accounts, 2013-2021[1/]

(Billions of euros)

	2013	2014	2015	Projections 2016	2017	2018	2019	2020	2021
Revenue	76.8	77.2	79.0	79.8	82.8	84.1	85.9	87.8	89.8
Taxes	42.7	43.6	45.5	45.8	46.8	47.9	49.1	50.2	51.3
Taxes on production and imports	23.3	24.6	26.1	27.2	28.0	28.8	29.5	30.3	31.0
Current taxes on income, wealth, etc. and capital taxes	19.4	19.0	19.4	18.5	18.8	19.2	19.5	19.9	20.3
Current taxes on income, wealth, etc.	19.4	19.0	19.4	18.5	18.8	19.2	19.5	19.9	20.3
Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	20.4	20.5	20.8	21.5	22.2	22.5	22.9	23.2	23.7
Grants and other revenue	13.6	13.2	12.7	12.5	13.8	13.6	14.0	14.4	14.8
Property income	2.1	1.7	1.3	1.3	1.5	1.5	1.5	1.6	1.6
Sales of goods and services	6.5	6.3	6.6	6.7	6.9	7.1	7.3	7.5	7.7
Other current revenue	3.1	3.4	3.2	3.1	3.5	3.5	3.6	3.6	3.7
Capital transfers and investment grants	1.9	1.7	1.5	1.5	2.0	1.6	1.6	1.7	1.7
Expenditure	85.0	89.6	86.8	84.6	86.8	88.5	90.4	92.4	94.7
Expense	86.3	91.2	87.8	86.4	88.6	90.3	92.3	94.3	96.7
Compensation of employees	21.3	20.5	20.3	20.9	21.3	21.6	21.9	22.2	22.6
Use of goods and services	9.6	9.8	10.3	10.6	11.0	11.3	11.6	11.9	12.2
Consumption of fixed capital	5.1	5.1	5.2	5.4	5.5	5.7	5.8	6.0	6.2
Interest	8.3	8.5	8.2	8.0	8.2	8.3	8.4	8.5	8.9
Subsidies	1.0	1.2	1.1	1.1	1.1	1.1	1.1	1.2	1.2
Social benefits	34.8	34.1	34.6	35.0	35.8	36.5	37.4	38.3	39.2
Grants and other expense	6.2	11.9	8.0	5.4	5.7	5.8	6.0	6.1	6.3
Other current expense	4.6	4.7	4.6	4.8	4.9	5.1	5.2	5.3	5.5
Capital transfers	1.5	7.2	3.4	0.6	0.7	0.8	0.8	0.8	0.8
Net acquisition of nonfinancial assets	-1.2	-1.6	-0.9	-1.8	-1.8	-1.8	-1.9	-1.9	-2.0
Gross fixed capital formation	3.8	3.5	4.3	3.6	3.8	3.9	4.0	4.1	4.2
(-) Consumption of fixed capital	-5.1	-5.1	-5.2	-5.4	-5.5	-5.7	-5.8	-6.0	-6.2
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-4.4	-8.9	-3.5	-1.2	-0.2	-0.5	-0.5	-0.5	-0.7
Net lending (+)/borrowing (–)	-8.2	-12.4	-7.8	-4.7	-3.9	-4.4	-4.4	-4.6	-4.8
Net acquisition of financial assets	-1.8	-6.5	-4.2	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	1.2	0.0	-3.1	...	...	...	...	...	...
Debt securities	-0.3	-4.7	-1.0	...	...	...	...	...	...
Loans	0.3	-0.1	0.2	...	...	...	...	...	...
Equity and investment fund shares	-1.1	-2.1	-0.2	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.1	-0.3	...	...	...	...	...	...
Other accounts receivable	-1.9	0.3	0.1	...	...	...	...	...	...
Net incurrence of liabilities	6.4	5.9	3.6	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	1.2	4.9	4.0	...	...	...	...	...	...
Debt securities	-2.8	-1.8	11.2	...	...	...	...	...	...
Loans	9.0	3.6	-9.4	...	...	...	...	...	...
Equity and investment fund shares	-0.3	0.0	-0.1	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts payable	-0.7	-0.8	-2.0	...	...	...	...	...	...
Memorandum items:									
Primary balance	0.0	-3.9	0.4	3.3	4.2	3.9	3.9	3.9	4.1
Debt at face value (EDP notification)	219.7	226.0	231.6	241.6	246.3	250.5	254.4	259.3	264.2
Nominal GDP	170.3	173.1	179.5	184.7	189.7	194.6	199.9	205.4	210.9

Sources: INE; Bank of Portugal; and IMF staff projections.

[1] GFSM 2001 presentation.

Table 2b. General Government Accounts, 2013-2021[1/]

(Percent of GDP, unless otherwise noted)

				Projections					
	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue	45.1	44.6	44.0	43.2	43.7	43.2	43.0	42.7	42.6
Taxes	25.1	25.2	25.4	24.8	24.7	24.6	24.5	24.4	24.3
Taxes on production and imports	13.7	14.2	14.5	14.7	14.8	14.8	14.8	14.7	14.7
Current taxes on income, wealth, etc. and capital taxes	11.4	11.0	10.8	10.0	9.9	9.8	9.8	9.7	9.6
Social contributions	12.0	11.8	11.6	11.7	11.7	11.6	11.4	11.3	11.3
Grants and other revenue	8.0	7.6	7.1	6.8	7.3	7.0	7.0	7.0	7.0
Property income	1.3	1.0	0.7	0.7	0.8	0.8	0.8	0.8	0.8
Sales of goods and services	3.8	3.6	3.7	3.6	3.7	3.7	3.7	3.7	3.7
Other current revenue	1.8	2.0	1.8	1.7	1.8	1.8	1.8	1.8	1.8
Capital transfers and investment grants	1.1	1.0	0.9	0.8	1.0	0.8	0.8	0.8	0.8
Expenditure	49.9	51.8	48.4	45.8	45.7	45.5	45.2	45.0	44.9
Expense	50.7	52.7	48.9	46.8	46.7	46.4	46.1	45.9	45.8
Compensation of employees	12.5	11.9	11.3	11.3	11.2	11.1	11.0	10.8	10.7
Use of goods and services	5.6	5.7	5.8	5.8	5.8	5.8	5.8	5.8	5.8
Consumption of fixed capital	3.0	2.9	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Interest	4.9	4.9	4.6	4.3	4.3	4.3	4.2	4.2	4.2
Subsidies	0.6	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Social benefits	20.4	19.7	19.3	18.9	18.9	18.8	18.7	18.7	18.6
Grants and other expense	3.6	6.9	4.4	2.9	3.0	3.0	3.0	3.0	3.0
Other current expense	2.7	2.7	2.5	2.6	2.6	2.6	2.6	2.6	2.6
Capital transfers	0.9	4.2	1.9	0.3	0.4	0.4	0.4	0.4	0.4
Net acquisition of nonfinancial assets	-0.7	-0.9	-0.5	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9
Gross fixed capital formation	2.3	2.0	2.4	1.9	2.0	2.0	2.0	2.0	2.0
(-) Consumption of fixed capital	-3.0	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9	-2.9
Acquisitions less disposals of other nonfinancial assets	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross Operating Balance	-2.6	-5.1	-2.0	-0.6	-0.1	-0.3	-0.2	-0.3	-0.3
Net lending (+)/borrowing (–)	-4.8	-7.2	-4.4	-2.6	-2.1	-2.3	-2.2	-2.2	-2.3
Net acquisition of financial assets	-1.1	-3.8	-2.4	...	...	...	...	...	...
Monetary gold and SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	0.7	0.0	-1.7	...	...	...	...	...	...
Debt securities	-0.2	-2.7	-0.5	...	...	...	...	...	...
Loans	0.2	-0.1	0.1	...	...	...	...	...	...
Equity and investment fund shares	-0.6	-1.2	-0.1	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.1	-0.2	...	...	...	...	...	...
Other accounts receivable	-1.1	0.2	0.0	...	...	...	...	...	...
Net incurrence of liabilities	3.8	3.4	2.0	...	...	...	...	...	...
SDRs	0.0	0.0	0.0	...	...	...	...	...	...
Currency and deposits	0.7	2.8	2.2	...	...	...	...	...	...
Debt securities	-1.6	-1.1	6.2	...	...	...	...	...	...
Loans	5.3	2.1	-5.2	...	...	...	...	...	...
Equity and investment fund shares	-0.2	0.0	-0.1	...	...	...	...	...	...
Insurance, pensions, and standardized guarantee schemes	0.0	0.0	0.0	...	...	...	...	...	...
Financial derivatives and employee stock options	0.0	0.0	0.0	...	...	...	...	...	...
Other accounts payable	-0.4	-0.5	-1.1	...	...	...	...	...	...
Memorandum items:									
Primary balance	0.0	-2.3	0.2	1.8	2.2	2.0	2.0	1.9	1.9
Structural balance (Percent of potential GDP)	-2.1	-0.8	-1.1	-1.5	-1.7	-2.0	-2.2	-2.4	-2.5
Structural primary balance (Percent of potential GDP)	2.5	3.8	3.3	2.7	2.6	2.3	2.0	1.8	1.8
Debt at face value (EDP notification)	129.0	130.6	129.0	130.8	129.8	128.7	127.2	126.2	125.3
Nominal GDP (Billions of euros)	170.3	173.1	179.5	184.7	189.7	194.6	199.9	205.4	210.9

Sources: INE; Bank of Portugal; and IMF staff projections.

[1] GFSM 2001 presentation.

Table 3. Portugal: Monetary Survey, 2013–2021

(Millions of euros, unless otherwise indicated; end of period)

				Est.	Projections				
	2013	2014	2015	2016	2017	2018	2019	2020	2021
Aggregated Balance Sheet of Monetary Financial Institutions (MFIs)[1]									
Assets	427,412	405,080	389,879	380,510	389,273	390,188	393,710	402,954	410,094
Claims on Bank of Portugal	9,841	5,093	9,353	8,096	7,853	7,617	7,389	7,167	6,952
Claims on non-residents	71,566	70,851	63,362	58,927	59,516	60,111	60,712	61,319	61,933
Claims on non-monetary resident sector	329,203	307,411	296,233	293,668	301,079	301,935	305,219	313,888	320,711
General government	38,693	41,504	39,948	47,576	51,651	53,403	55,736	60,172	63,886
Central government	32,935	34,990	33,634	41,201	45,268	46,956	49,289	53,481	57,166
Loans	1,725	3,092	2,547	5,311	7,966	9,453	13,808	17,493	20,792
Securities	31,210	30,072	29,087	34,581	35,988	35,492	33,470	33,977	34,388
General government, excluding central government	5,758	6,514	6,314	6,375	6,384	6,448	6,447	6,690	6,720
Private sector	243,818	224,406	215,205	210,470	209,418	209,628	211,305	214,685	218,120
Non-financial corporations	115,703	100,721	95,981	95,690	96,413	97,060	97,726	98,413	99,121
Private individuals[2]	128,115	123,685	119,224	114,780	113,005	112,568	113,579	116,273	119,000
Non-monetary financial institutions	46,693	43,327	41,081	35,622	40,010	38,904	38,179	39,031	38,705
Other assets	16,802	21,725	20,931	19,819	20,825	20,525	20,390	20,580	20,498
Liabilities	427,412	405,080	389,879	380,510	389,273	390,188	393,710	402,954	410,094
Liabilities to Bank of Portugal	48,810	32,503	29,616	25,174	24,418	23,686	22,975	22,286	21,617
Liabilities to non-residents	70,135	67,639	58,926	57,747	56,593	55,461	54,351	53,264	52,199
Liabilities to non-monetary resident sector	217,918	216,943	216,963	220,339	227,642	234,956	237,630	243,652	248,503
General government	12,429	12,741	11,545	14,771	12,771	15,571	13,171	12,461	11,421
Central government	9,222	9,120	6,667	8,530	7,375	8,992	7,606	7,196	6,595
General government, excluding central government	3,207	3,621	4,878	6,241	5,396	6,579	5,565	5,265	4,825
Private sector[3]	161,728	163,139	168,061	173,175	178,488	184,007	189,741	195,698	201,885
Non-monetary financial institutions	43,761	41,062	37,358	32,393	36,384	35,378	34,719	35,494	35,197
Securities other than capital	37,858	28,670	24,404	18,303	18,852	19,418	20,000	20,600	21,218
Capital and reserves	52,691	59,325	59,970	58,947	61,768	56,668	58,753	63,152	66,556
Money and Credit									
Broad money (M3)	147,774	146,488	153,193	156,833	160,296	163,655	167,289	171,032	174,750
Intermediate money (M2)	143,949	143,762	150,413	153,987	157,387	160,685	164,253	167,929	171,579
Narrow money (M1)	50,475	54,989	66,400	67,978	69,479	70,935	72,510	74,132	75,744
Private sector credit	243,818	224,406	215,205	210,470	209,418	209,628	211,305	214,685	218,120
Public sector credit	38,693	41,504	39,948	47,576	51,651	53,403	55,736	60,172	63,886
(Percent of GDP)									
Broad money	86.8	84.6	85.3	84.9	84.5	84.1	83.7	83.3	82.9
Private sector credit	143.2	129.7	119.9	114.0	110.4	107.7	105.7	104.5	103.4
Public sector credit	22.7	24.0	22.3	25.8	27.2	27.4	27.9	29.3	30.3
(Percentage change)									
Broad money	0.2	-0.9	4.6	2.4	2.2	2.1	2.2	2.2	2.2
Private sector credit	-5.2	-8.0	-4.1	-2.2	-0.5	0.1	0.8	1.6	1.6
Public sector credit	-0.2	7.3	-3.7	19.1	8.6	3.4	4.4	8.0	6.2
Memorandum items:									
ECB access (Percent of assets)	11.4	8.0	7.6	6.6	6.3	6.1	5.8	5.5	5.3
Credit to deposits (Percent)	129.6	122.6	117.6	117.1	114.7	111.9	112.4	112.8	113.5
Loan to deposits (Percent)	111.0	105.4	100.6	98.2	95.8	93.5	95.0	95.5	96.4
Wholesale market funding (Percent of assets)[3]	21.4	19.6	16.6	15.7	15.8	16.3	16.6	16.7	16.9

Sources: Haver Analytics; Bank of Portugal; and IMF Staff Estimates.

1/Excludes Bank of Portugal.

2/ Including emigrants.

3/ Includes foreign interbank borrowing and securities issued.

Table 4. Portugal: Balance of Payments, 2013–2021
(In billions of euros)

				Est.	Projections				
	2013	2014	2015	2016	2017	2018	2019	2020	2021
				(Billions of euros)					
Current account	2.6	0.1	0.8	0.5	-1.1	-1.3	-1.8	-2.3	-2.9
Balance of goods and services	3.2	2.0	3.3	3.8	2.5	2.1	1.6	1.2	0.5
Trade balance	-8.0	-9.5	-9.1	-9.4	-11.3	-12.4	-13.6	-14.9	-16.3
Exports fob	46.5	47.3	49.2	48.9	54.3	57.8	61.0	64.3	67.6
Imports fob	54.5	56.8	58.3	58.3	65.6	70.2	74.7	79.3	83.8
Services, net	11.2	11.5	12.4	13.2	13.7	14.4	15.2	16.1	16.8
Exports	22.1	23.5	25.3	26.2	27.6	29.0	30.6	32.3	33.6
Imports	10.9	12.1	12.9	13.0	13.9	14.5	15.3	16.2	16.9
Of which:									
Tourism	6.1	7.1	7.8	8.8	9.2	9.7	10.2	10.8	11.3
Exports	9.2	10.4	11.5	12.6	13.2	13.8	14.6	15.4	16.1
Imports	3.1	3.3	3.6	3.7	3.9	4.1	4.4	4.6	4.8
Primary income, net	-2.1	-3.1	-4.0	-4.3	-4.3	-4.1	-4.2	-4.2	-4.2
Secondary income, net	1.5	1.3	1.5	0.9	0.8	0.7	0.7	0.8	0.8
Private remittances, net	3.1	3.0	3.1	2.6	2.5	2.5	2.5	2.6	2.7
Official transfers, net	-1.6	-1.7	-1.6	-1.7	-1.7	-1.7	-1.8	-1.8	-1.8
Capital account	2.8	2.6	2.2	1.8	2.1	2.1	2.1	2.1	2.2
Financial account	17.5	8.2	2.9	2.2	1.1	0.9	0.3	-0.1	-0.7
Direct investment	-3.0	-2.7	-1.0	-1.5	-1.5	-1.5	-1.5	-1.4	-1.4
Direct investment assets	5.1	7.1	-0.4	1.1	1.1	1.2	1.2	1.2	1.3
Direct investment liabilities	8.2	9.8	0.6	2.6	2.6	2.6	2.7	2.7	2.7
Portfolio investment, net	3.8	-1.2	0.3	3.5	1.9	2.0	2.0	2.1	2.1
Financial derivatives	1.0	1.9	0.4	0.2	0.2	0.2	0.2	0.2	0.2
Other investment, net	15.3	8.5	1.7	-1.0	0.0	-0.1	-0.6	-1.0	-1.7
Reserve assets	0.4	1.7	1.5	0.9	0.5	0.2	0.1	0.1	0.0
Errors and omissions	0.4	0.3	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Net international investment position[1]	-197.9	-198.9	-196.3	-194.1	-193.0	-192.2	-191.8	-192.0	-192.7
Direct investment, net	-46.3	-49.1	-50.8	-52.3	-53.7	-55.2	-56.6	-58.1	-59.5
Portfolio investment, net	-18.3	-19.5	-18.4	-14.9	-13.0	-11.0	-9.0	-6.9	-4.8
Financial derivatives	-3.1	-1.8	0.1	0.3	0.5	0.7	0.9	1.2	1.4
Other investment, net	-143.0	-144.7	-145.0	-146.0	-146.0	-146.1	-146.7	-147.7	-149.4
Reserve assets	12.7	16.2	17.8	18.7	19.2	19.4	19.5	19.6	19.6
Nominal GDP	170.3	173.1	179.5	184.7	189.706	194.6	199.9	205.4	210.9
Current account	1.5	0.1	0.4	0.3	-0.6	-0.7	-0.9	-1.1	-1.4
Current account (Including capital transfers)	3.2	1.5	1.7	1.2	0.6	0.4	0.2	-0.1	-0.3
Of which: Balance of goods and services	1.9	1.1	1.8	2.1	1.3	1.1	0.8	0.6	0.2
Net international investment position[1]	-116.3	-114.9	-109.3	-105.1	-101.7	-98.7	-96.0	-93.5	-91.4
Direct investment, net	-27.2	-28.4	-28.3	-28.3	-28.3	-28.4	-28.3	-28.3	-28.2
Portfolio investment, net	-10.7	-11.3	-10.3	-8.1	-6.8	-5.7	-4.5	-3.4	-2.3
Financial derivatives	-1.8	-1.0	0.1	0.2	0.3	0.4	0.5	0.6	0.7
Other investment, net	-84.0	-83.6	-80.8	-79.0	-77.0	-75.1	-73.4	-71.9	-70.8
Reserve assets	7.5	9.3	9.9	10.1	10.1	10.0	9.8	9.5	9.3

Sources: Bank of Portugal; and IMF staff estimates.

1/ End-of-period data.

Table 5. Portugal: Financial Soundness Indicators, 2013:Q1-2016:Q2[1/]
(Percent)

	2013				2014				2015				2016	
	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
Capital adequacy														
Regulatory capital to risk-weighted assets	13.0	13.1	13.4	13.3	12.3	12.0	13.0	12.3	12.0	12.5	12.6	13.3	13.0	13.1
Common Equity Tier 1 capital to risk-weighted assets					12.2	10.6	12.0	11.3	11.1	11.6	11.7	12.4	12.1	12.1
Regulatory tier 1 capital to risk-weighted assets	11.7	11.7	12.0	11.9	11.1	10.7	12.1	11.4	11.2	11.7	11.8	12.6	12.3	12.4
Capital to assets 2/	6.9	6.7	6.9	6.9	7.4	7.2	8.1	7.7	8.0	7.8	8.1	8.5	8.5	8.3
Asset composition and quality														
Non-performing loans to total gross loans 3/	10.4	10.6	11.2	10.6	10.8	11.2	12.0	11.9	12.3	12.6	12.9	12.0	12.3	12.7
Sectoral distribution of loans														
Residents	83.2	83.9	86.7	86.8	86.1	85.8	84.8	85.6	85.7	86.0	87.7	88.0	88.5	88.5
Nonresidents	16.8	16.1	13.3	13.2	13.9	14.2	15.2	14.4	14.3	14.0	12.3	12.0	11.5	11.5
Earnings and profitability														
Return on assets	-0.3	-0.5	-0.5	-0.7	0.0	-1.8	-1.5	-1.3	0.5	0.5	0.3	0.2	0.2	0.0
Return on equity	-3.7	-8.0	-7.5	-11.0	-0.4	-24.8	-19.8	-17.8	6.4	6.0	3.6	2.9	2.4	0.3
Interest margin to gross income	41.7	43.4	46.0	47.7	46.3	47.9	49.1	50.0	44.7	46.2	49.4	49.3	60.2	56.4
Noninterest expenses to gross income	66.2	66.6	68.5	70.4	59.5	66.9	67.0	67.3	53.3	55.0	59.6	59.4	65.3	61.9
Liquidity														
Liquid assets to total assets 4/	15.4	16.0	15.7	16.9	16.7	16.2	17.2	22.0	19.4	19.4	19.2	20.2	20.2	14.4
Liquid assets to short-term liabilities 4/	145.9	150.7	155.1	170.3	155.6	157.3	146.8	154.2	154.7	169.4	173.0	206.4	187.6	232.5
Loans to deposits 5/	124.0	122.6	120.7	116.9	117.2	113.9	111.9	107.2	106.9	106.0	104.6	102.6	102.5	102.5
Foreign-currency-denominated liabilities to total liabilities 6/	4.5	4.4	4.4	4.3	4.3	4.7	4.8	4.5	4.6	4.5	4.4	4.1	4.1	4.0

Source: Bank of Portugal.

1/ The banking system data present a break in time series in 2014Q3 due to the resolution measure applied to Banco Espírito Santo (BES). The break in time series stems, in particular, from the fact that the assets/liabilities not transferred to the balance sheet of Novo Banco (NB) are not considered in the aggregate of the banking system from August 2014 onwards. In the absence of accounting information for BES on a consolidated basis for the period from 30 June 2014 to the day of implementation of the resolution measure (closing balance sheet and statement of profit or loss), the reporting of BES on an individual basis, with reference to 31 July 2014, was considered when determining the aggregate results of the banking system for 2014Q3. However, the adjustments stemming from the resolution measure applied to BES were also not considered.

2/ On accounting basis; consolidated.

3/ According to the Financial Soundness Indicators methodological note, non-performing loans refer to the national concept of credit at risk. On a consolidated basis.

4/ Three-month residual maturity. Data on liquid assets in 2016:Q2 contain a break as only domestic institutions are considered in the compilation.

5/ Loans to customers (net of impairments) and securitized non-derecognized credit to customers divided by resources from customers and other loans.

6/ Includes foreign currency deposits and deposit-like instruments of resident nonmonetary sector and claims of nonresident vis-à-vis resident monetary financial institutions (excluding Bank of Portugal).

Table 6. Portugal: External Debt Sustainability Framework, 2013-2021

(Percent GDP unless otherwise indicated)

				Est.	Projections					
	2013	2014	2015	2016	2017	2018	2019	2020	2021	Debt-stabilizing non-interest current account[6]
Baseline: External debt	226.9	235.5	221.8	213.9	208.3	204.6	199.8	195.5	191.6	-4.0
Change in external debt	-10.8	8.6	-13.7	-7.9	-5.7	-3.6	-4.8	-4.3	-3.9	
Identified external debt-creating flows (4+8+9)	-4.2	-3.8	-12.0	-5.4	-4.8	-4.3	-4.0	-3.5	-3.0	
Current account deficit, excluding interest payments	-7.4	-5.4	-5.4	-4.7	-3.7	-3.5	-2.9	-2.7	-2.2	
Deficit in balance of goods and services	-1.9	-1.1	-1.8	-2.1	-1.3	-1.1	-0.8	-0.6	-0.2	
Exports	40.3	40.9	41.5	40.7	43.2	44.6	45.8	47.1	48.0	
Imports	38.4	39.8	39.7	38.6	41.9	43.5	45.0	46.5	47.7	
Net non-debt creating capital inflows (negative)	-0.1	-0.1	-3.1	-2.4	-2.6	-2.6	-2.6	-2.6	-2.5	
Automatic debt dynamics[1]	3.3	1.6	-3.4	1.7	1.5	1.7	1.5	1.8	1.8	
Contribution from nominal interest rate	5.9	5.3	5.0	4.5	4.3	4.1	3.8	3.9	3.6	
Contribution from real GDP growth	2.7	-2.0	-3.6	-2.8	-2.8	-2.4	-2.3	-2.1	-1.8	
Contribution from price and exchange rate changes[2]	-5.3	-1.7	-4.9	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3)[3]	-6.6	12.4	-1.7	-2.5	-0.9	0.7	-0.8	-0.7	-0.9	
External debt-to-exports ratio (Percent)	563.1	575.6	534.5	526.2	482.2	458.9	436.0	415.4	399.4	
Gross external financing need (Billions of Euros)[4]	188.5	188.7	161.1	170.2	165.8	163.9	168.6	172.5	176.9	
Percent of GDP	110.7	109.0	89.7	92.1	87.4	84.2	84.3	84.0	83.9	
Scenario with key variables at their historical averages[5]				213.9	218.0	223.8	228.5	233.4	238.4	4.5
Key Macroeconomic Assumptions Underlying Baseline										
Real GDP growth (Percent)	-1.1	0.9	1.6	1.3	1.3	1.2	1.2	1.1	1.0	
GDP deflator in Euros (Percent)	2.3	0.8	2.1	1.6	1.4	1.4	1.5	1.7	1.7	
Nominal external interest rate (Percent)	2.5	2.4	2.2	2.1	2.0	2.0	1.9	2.0	1.9	
Growth of exports (Euros, percent)	6.6	3.2	5.2	0.8	9.1	5.9	5.6	5.5	4.7	
Growth of imports (Euros, percent)	2.0	5.2	3.4	0.1	11.4	6.7	6.2	6.1	5.4	
Current account balance, excluding interest payments	7.4	5.4	5.4	4.7	3.7	3.5	2.9	2.7	2.2	
Net non-debt creating capital inflows	0.1	0.1	3.1	2.4	2.6	2.6	2.6	2.6	2.5	

Source: Fund staff estimates.

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency--not used here), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 7. Portugal: Indicators of Fund Credit, 2011–2021[1/]

(Millions of euros, unless otherwise indicated)

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Disbursements	13,050	8,219	3,406	1,786	…	…	…	…	…	…	…	…
(Percent of quota)	1,117	670	289	152	…	…	…	…	…	…	…	…
(Projected debt service to the Fund, based on existing and prospective drawings)												
Total	178	460	621	822	9,309	5,126	549	544	4,694	5,145	4,353	1,972
Interest and charges	178	460	621	822	861	629	549	544	502	308	108	29
Repayments	0	0	0	0	8,448	4,496	0	0	4,192	4,836	4,245	1,943
Total debt service, in percent of												
Exports of goods and services	0.3	0.7	0.9	1.2	12.4	6.8	0.7	0.6	5.1	5.3	4.3	1.8
GDP	0.1	0.3	0.4	0.5	5.1	2.8	0.3	0.3	2.3	2.5	2.1	0.9
(Projected level of credit outstanding based on existing and prospective drawings)												
Outstanding stock	13,494	21,583	23,998	27,105	20,827	16,327	16,213	16,228	12,019	7,175	2,929	985
Percent of quota[2]	1,117.1	1,787.1	2,076.2	2,228.0	1,589.1	621.5	621.5	621.5	460.9	275.3	112.4	37.8
Percent of GDP	7.7	12.8	14.1	15.7	11.6	8.8	8.5	8.3	6.0	3.5	1.4	0.5
Memorandum Items (Billions of euros)												
Exports of goods and services	62	64	69	71	75	75	82	87	92	97	101	107
GDP	176	168	170	173	180	185	190	195	200	205	211	219

Source: IMF staff estimates.

1/ Exchange rates reflect actual exchange rates where available, otherwise historical and projected WEO annual averages for flows and end-of-period values for stocks.

2/ Quota Increase in 2016

Table 8. Portugal: General Government Financing Requirements and Sources, 2017-2021[1]

(Billions of euros)

	2017	2018	2019	2020	2021
Gross borrowing need	26.4	25.6	33.8	34.3	39.7
Overall balance	3.9	4.4	4.4	4.6	4.8
Amortization	19.2	20.7	28.8	29.1	34.7
Medium- and long-term	7.9	9.4	13.3	13.0	19.2
Residents	3.2	3.6	6.3	5.2	10.0
Non-residents	4.7	5.8	7.0	7.8	9.2
Short-term[2]	11.3	11.3	11.3	11.3	11.3
Residents	7.2	7.2	7.2	7.2	7.2
Non-residents	4.1	4.1	4.1	4.1	4.1
EU and IMF[3]	0.0	0.0	4.2	4.8	4.2
Other (Net)[4]	3.2	0.5	0.6	0.6	0.1
Gross financing sources	26.4	25.6	33.8	34.3	39.7
Privatization receipts	0.0	0.0	0.0	0.0	0.0
Market access	24.0	24.9	32.8	34.1	39.7
Medium- and long-term	12.7	13.6	21.5	22.8	28.4
Residents	5.9	6.0	9.7	9.6	12.4
Non-residents	6.8	7.6	11.7	13.2	16.0
Short-term[2]	11.3	11.3	11.3	11.3	11.3
Residents	7.2	7.2	7.2	7.2	7.2
Non-residents	4.1	4.1	4.1	4.1	4.1
Use of deposits[5]	2.4	0.7	1.0	0.2	0.0
Net placement (Market access-amortization)	4.7	4.2	4.0	5.0	5.0
Residents	2.7	2.4	2.4	3.2	1.3
Medium- and long-term	2.7	2.4	2.4	3.2	1.3
Short-term (Net increase)	0.0	0.0	0.0	0.0	0.0
Non-residents	2.1	1.8	1.6	1.8	3.7
Medium- and long-term	2.1	1.8	1.6	1.8	3.7
Short-term (Net increase)	0.0	0.0	0.0	0.0	0.0

Source: Portuguese authorities and IMF staff estimates.

1/ The coverage of this table has been expanded to fully reflect all general government (including local and regional governments and SOES) financing operations. However, data are on a non-consolidated basis (with intra-government flows presented where available). On a consolidated basis, they are smaller, by the amount of intra-government transactions.

2/ For projection years, all t-bills issuance is assumed to be short term (i.e. at maturities of 12 months or below).

3/ For EFSF loans, outstanding loans are assumed to be rolled over for an additional 7 years, as agreed with the EU. Projections assume no further advanced Fund repurchases; Portugal's next repurchase is not due until April 2019.

4/ Includes use of Bank Solvency Support Facility and other net financial transactions, net financing from retail government securities programs, as well as adjustments for cash-accrual differences and consistency between annual projections and preliminary quarterly accounts.

5/ Changes in government deposits (including deposits in BSSF).

Table 9. Portugal: External Financing Requirements and Sources, 2017-2021 1/

(Billions of euros)

	Projections				
	2017	2018	2019	2020	2021
Gross financing requirements	160.2	161.3	168.2	172.2	176.8
Current account deficit	1.1	1.3	1.8	2.3	2.9
Medium- and long-term debt amortization	27.4	30.9	33.5	36.6	41.3
Public sector	7.4	5.8	7.0	7.8	9.2
Banks	15.6	19.7	19.9	20.2	20.5
Other private	4.4	5.4	6.5	8.7	11.6
Short-term debt amortization	131.7	129.1	128.7	128.5	128.4
Public sector	81.9	81.2	80.4	79.7	79.0
Central Bank	77.9	77.1	76.4	75.7	75.0
Of which: ECB access	21.7	21.0	20.2	19.5	18.8
General government and SOEs	4.1	4.1	4.1	4.1	4.1
Banks	34.8	34.4	36.1	37.8	39.5
Other private	15.0	13.5	12.2	10.9	9.8
EU and IMF[1]	0.0	0.0	4.2	4.8	4.2
Sources of financing	160.2	161.3	168.2	172.2	176.8
Capital account (Net)	2.1	2.1	2.1	2.1	2.2
Foreign direct investment (Net)	-1.5	-1.5	-1.5	-1.4	-1.4
Inward	2.6	2.6	2.7	2.7	2.7
New borrowing and debt rollover	159.1	163.3	167.6	172.1	176.5
Medium and long-term borrowing	30.0	34.5	39.1	43.7	48.0
General government	9.7	8.2	11.4	13.5	14.6
Banks	15.5	20.9	21.2	21.5	21.8
Other private	4.8	5.4	6.5	8.7	11.6
Short-term borrowing	129.1	128.7	128.5	128.4	128.5
Public sector	81.2	80.4	79.7	79.0	78.4
Central bank	77.1	76.4	75.7	75.0	74.3
Of which: ECB access	21.0	20.2	19.5	18.8	18.2
General government	4.1	4.1	4.1	4.1	4.1
Banks	34.4	36.1	37.8	39.5	41.3
Other private	13.5	12.2	10.9	9.8	8.9
Other (Includes asset operations)	0.4	-2.6	-0.1	-0.6	-0.4
Of which: Net errors and omissions	0.0	0.0	0.0	0.0	0.0
Rollover rates					
General government	119.7	123.5	139.5	148.6	140.8
Private	97.8	102.2	102.4	102.5	102.5
Banks	99.0	105.5	105.3	105.2	105.0
Other private	94.5	92.9	93.5	94.4	95.4

Sources: Bank of Portugal and IMF staff estimates.

1/ For EFSF loans, outstanding loans are assumed to be rolled over for an additional 7 years, as agreed with the EU. Projections assume no further advanced Fund repurchases; Portugal's next repurchase is not due until April 2019.

Annex I. Public Debt Sustainability Analysis (DSA)

Staff's analysis, applying the Public DSA framework for Market-Access Countries, suggests that Portugal's gross debt trajectory is subject to significant risks, in the context of a sizable debt burden and gross financing needs. Debt dynamics remain vulnerable to adverse yet plausible macro-fiscal and contingent liabilities shocks, including the possible need for further fiscal support for the financial sector. The risk of a contingent liabilities shock materializing remains elevated, in light of financial sector vulnerabilities. Staff's baseline projections reflect the authorities' current fiscal policies; additional fiscal consolidation remains critical to anchor debt safely on a downward-sloping path, boosting policy credibility and strengthening the country's resilience to reversals in market sentiment.

A. Baseline Scenario

1. Public debt is now projected to rise in 2016, despite a downward revision to the fiscal deficit projection from the Article IV staff report, due to costs for bank recapitalization. While the fiscal deficit is now projected at 2.6 percent of GDP, compared to the previous projection of 3 percent, the public contribution to the recapitalization of CGD is expected to be 1.5 percent of GDP. As a result, public debt is now projected to rise from 129.1 to 130.8 percent of GDP at end-2016, slightly above the previous peak of 130.6 percent in 2014. Portugal's public debt net of central government deposits is projected to decline slightly from 121.6 percent to 121.3 percent of GDP. A modest decline in public debt is then projected through 2021 as the headline fiscal deficit stabilizes at around 2 ¼ percent of GDP, but public debt would still remain elevated at 124.9 percent of GDP in 2021. Deposits are expected to decline in 2017 to fund the recapitalization of CGD, but the further drawdown of cash deposits from 2018–21 is projected to be modest, reflecting the authorities' intention to maintain cover for 6 months' refinancing needs. Potential proceeds from the sale of financial sector assets (including Novo Banco) have not been included in the baseline, reflecting considerable uncertainty over prospects for revenues from the sale of these assets.

B. Risk Assessment

2. Portugal's sizable debt burden and gross financing needs continue to pose significant risks to debt sustainability and leave debt dynamics very sensitive to macro shocks. As shown in Figure 1, Portugal's debt ratio already exceeds the debt burden benchmark for advanced economies of 85 percent of GDP under the baseline scenario. However, Portugal's public financing needs now fall slightly below the relevant benchmark of 20 percent of GDP during the projection period, as the combination of longer-term issuance and shorter-term debt buybacks over the past year has helped to moderate near-term refinancing needs and smooth the redemption profile of public debt.. The debt profile is subject to medium to low risks in terms of market perception, projected change in short-term debt, and the share of public debt held by nonresident.[1] Moreover, in the case of Portugal, since bank vulnerabilities are below the relevant thresholds identified by the MAC DSA template, the standardized contingent liabilities shock does not apply. Nevertheless, this

[1] The total (public and private) external financing requirements exceed significantly the relevant benchmark under the baseline. However, in the case of Portugal, the figure includes, among others, non-residents bank deposits, accounting for about 45 percent of GDP.

is replaced by a customized shock given the risks posed by the materialization of contingent liabilities from SOEs and PPPs (please refer to the stress test customized scenario).

C. Realism of Baseline Assumptions and Alternative Scenarios

3. Realizing the potential growth rate assumed in the current projection has important implications for the debt adjustment path. Portugal's growth forecast track record shows a relatively large median error compared with other countries with Fund-supported programs, especially during the pre-crisis period (Figure 2). The achievement of a growth rate of 1.2 percent over the medium term, as per staff's updated projection, is consistent with moderate growth convergence. If growth were to turn out lower than currently projected—for instance as a result of reversal of structural reforms—the rate of debt decline would significantly slow down, as also shown in Figures 4 and 5. Similarly, risks from a protracted period of negative inflation in Portugal could further impede the repair of already-weak private and public balance sheets, as highlighted by the customized deflation scenario in Figure 5.

4. Given Portugal's sizable debt burden and financing needs, the primary balance is expected to exceed its debt-stabilizing threshold over the projection period. Under staff's baseline scenario,[2] the fiscal primary balance is expected to stabilize at around 2 percent of GDP over the medium term. Nevertheless, Portugal's debt profile remains highly vulnerable to a primary balance shock (Figures 4 and 5), as also highlighted by the asymmetric fan chart analysis in Figure 1, which shows the risks to the debt outlook if only negative shocks to the primary balance were to materialize. The authorities' medium-term fiscal strategy under the Stability Program for 2016–20 envisages a reduction in public debt to 110.3 percent of GDP by 2020. However, this projection is based on a very ambitious timetable for fiscal adjustment and incorporates optimistic assumptions on both receipts from the sale of financial sector assets and medium-term growth. The Stability Program assumes annual real GDP growth of 2.0 percent in 2017–20, as opposed to staff's baseline projection of average annual growth of 1.2 percent over the same period.

D. Stress Test

5. The baseline remains highly sensitive to macro-fiscal and contingent liabilities shocks (Figure 5):

- Under a *growth shock* that lowers output by nearly 4.5 percentage points in 2016–17 (and in turn inflation by a cumulative 1 percentage point), debt would peak at about 139 percent of GDP in 2018, 9 percentage points higher than under the 2016 baseline. However, debt dynamics would be severely compromised under a *deflation scenario* where a sharper growth shock (that lowers output by 5½ percentage points in 2016–17) is associated with deflationary pressures (with inflation lower by cumulative 4 percentage points), in the context of a widening output gap

[2] In line with the WEO guidelines, medium-term assumptions that are not backed up by well-defined fiscal measures are not incorporated by the team under the baseline scenario.

and high unemployment. Under this scenario, debt would rise to 148 percent of GDP by 2018 and remain close to this level over the medium-term.

- A sustained interest rate shock of 280 basis points throughout the projection period is not expected to have a large immediate effect, but it would slow down the rate of debt decline in the medium term, so that by 2021 the debt-to-GDP ratio is about 3 points higher compared with the baseline.

- Further materialization of contingent liabilities would also have implications for Portugal's debt dynamics. While the recent debt management operation for SOEs has significantly addressed fiscal risks from the transport and infrastructure sectors, staff's assessment suggests that, under a severe scenario, further contingent liabilities could potentially materialize of about 10 percent of GDP, due to financial sector risks, SOEs, PPPs, and State guarantees.[3] A contingent liabilities shock of this magnitude would push the 2017 debt ratio to 140 percent of GDP.

- A severe combined shock that incorporates the macro-fiscal and contingent liabilities adverse scenarios mentioned above would significantly affect the country's debt dynamics, with debt rising to 148 percent of GDP in 2018 and then remaining at this level over the medium term.

6. The authorities took note of the risks highlighted by staff, but also stressed the divergence of their medium-term outlook from staff's baseline scenario. The authorities were optimistic that reforms in recent years have laid the foundation for stronger export-oriented growth, which would underpin a larger improvement in medium-term debt dynamics than projected by staff. In addition, they were confident that the 2017 fiscal deficit target will be achieved, resulting in a larger reduction of the debt-to-GDP ratio by the end of the year, and putting debt dynamics on a trajectory to improve at a faster pace than envisaged under staff's baseline scenario. Over the medium-term, the authorities reiterated their commitment to medium-term fiscal consolidation as outlined in their 2016 Stability Program and the 2017 Budget. In the near-term, they were optimistic that Portugal's record of fiscal adjustment and reform implementation under the adjustment program had strengthened their credibility with investors, and would enable them to avoid any prolonged deterioration in market access.

[3] Staff's assumptions for the adverse contingent liabilities scenario include (i) the hypothetical cost of further financial sector operations; (ii) staff's estimate of potential contingent liabilities from PPPs based on financial rebalancing requests by concessionaires; (iii) the hypothetical settlement of the outstanding stock of arrears; (iv) staff's estimate of potential contingent liabilities from other non-bank debt directly guaranteed by the State and/or classified outside the general government perimeter.

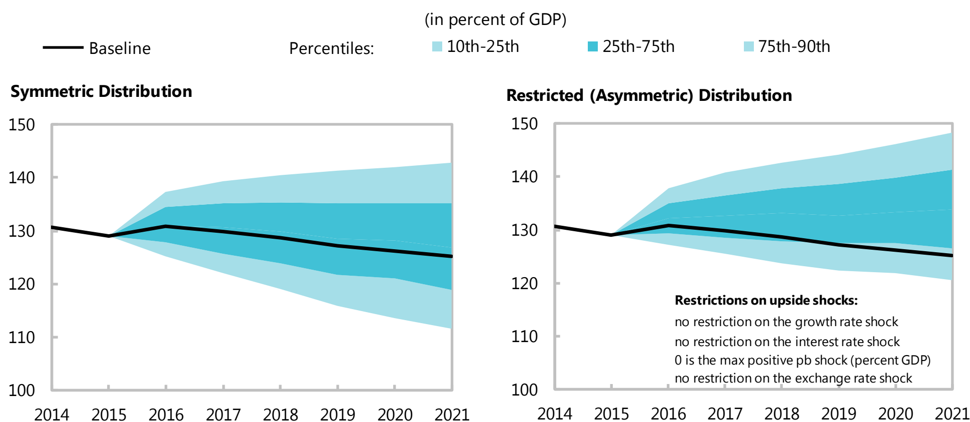
Figure 1. Portugal: Public DSA Risk Assessment, 2014–2021

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

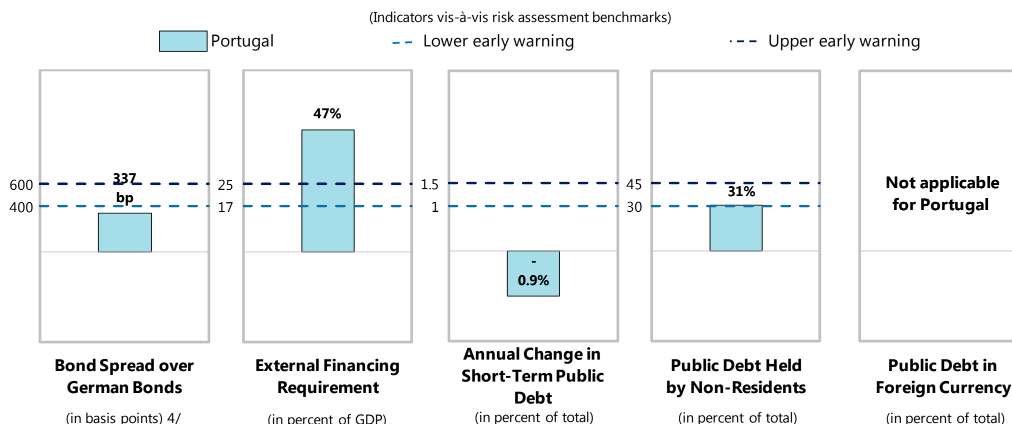
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks)



Source: IMF staff estimates.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant. In the case of Portugal, the benchmark is already exceeded under the baseline (implying that any specific shock, regardless of its size, is reported as red). Moreover, the standardized contingent liabilities shock of the MAC DSA template (based on bank vulnerabilities and below the relevant threshold for Portugal) is replaced by a customized shock based on contingent liabilities risks from SOEs and PPPs.

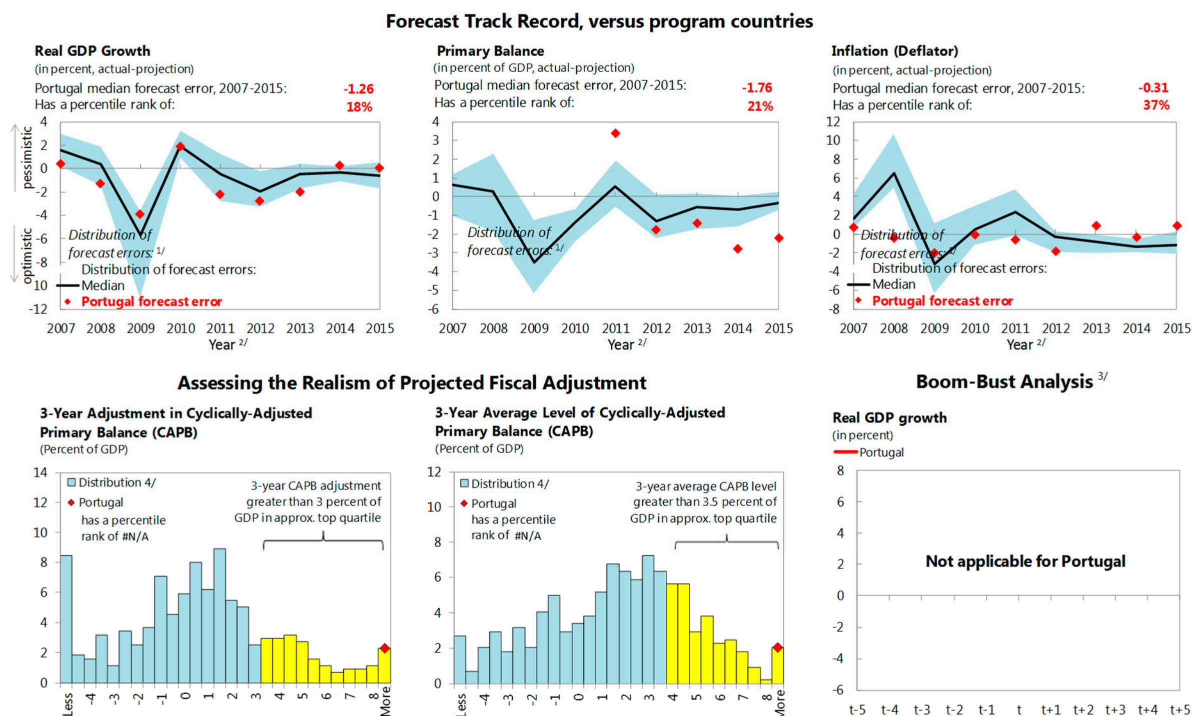
2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents. In the case of Portugal, the external financing requirements figure includes bank deposits by non-residents (accounting for about 45 percent of GDP).

4/ An average over the last 3 months, 14-Oct-16 through 12-Jan-17.

Figure 2. Portugal: Public DSA - Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes program countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Portugal, as it meets neither the positive output gap criterion nor the private credit growth criterion.

4/ Data cover annual observations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Portugal: Public Sector Debt Sustainability Analysis (DSA) Baseline Scenario, 2005–2021

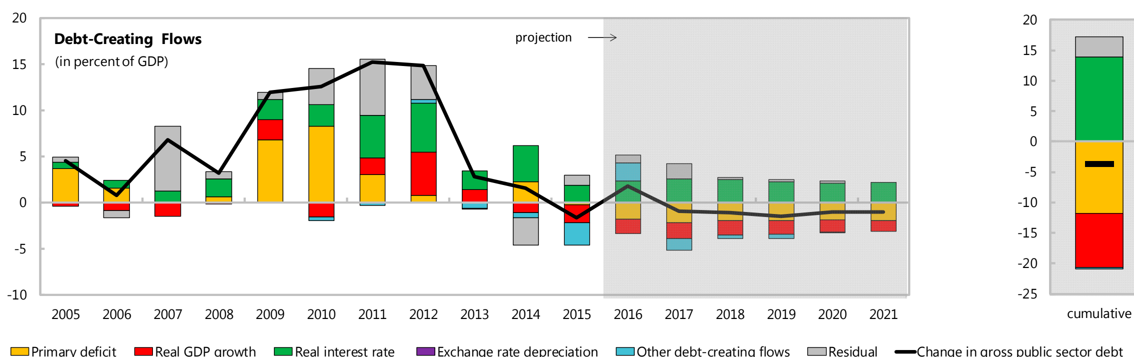
(Percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators [1]

	Actual		Prel.	Projections						As of January 12, 2017		
	2005-2013 [2]	2014	2015	2016	2017	2018	2019	2020	2021	Sovereign Spreads		
Nominal gross public debt	89.9	130.6	129.0	130.8	129.8	128.7	127.2	126.2	125.3	Spread (bp) 3/		359
Public gross financing needs	...	30.9	22.4	19.6	12.2	12.9	16.7	16.5	18.8	CDS (bp)		332
Real GDP growth (in percent)	-0.3	0.9	1.6	1.3	1.3	1.2	1.2	1.1	1.0	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	1.6	0.8	2.1	1.6	1.4	1.4	1.5	1.7	1.7	Moody's	Ba1	Ba1
Nominal GDP growth (in percent)	1.3	1.7	3.7	2.9	2.7	2.6	2.7	2.7	2.7	S&Ps	BB	BB
Effective interest rate (in percent) [4]	4.4	3.9	3.6	3.5	3.4	3.4	3.3	3.4	3.4	Fitch	BB+	BB+

Contribution to Changes in Public Debt

	Actual		Prel.	Projections							
	2005-2013	2014	2015	2016	2017	2018	2019	2020	2021	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	8.1	1.6	-1.6	1.8	-0.9	-1.1	-1.5	-1.0	-1.0	-3.7	
Identified debt-creating flows	5.6	4.6	-2.7	0.9	-2.6	-1.4	-1.7	-1.2	-1.0	-7.1	
Primary deficit	2.8	2.3	-0.2	-1.8	-2.2	-2.0	-2.0	-1.9	-1.9	-11.8	0.9
Primary (noninterest) revenue and grants	41.8	44.6	44.0	43.2	43.7	43.2	43.0	42.7	42.6	258.4	
Primary (noninterest) expenditure	44.5	46.9	43.8	41.4	41.4	41.2	41.0	40.8	40.7	246.6	
Automatic debt dynamics [5]	3.0	2.8	-0.1	0.7	0.9	1.0	0.8	0.8	0.9	5.0	
Interest rate/growth differential [6]	3.0	2.8	-0.1	0.7	0.9	1.0	0.8	0.8	0.9	5.0	
Of which: real interest rate	2.4	3.9	1.9	2.3	2.6	2.5	2.2	2.1	2.2	13.8	
Of which: real GDP growth	0.6	-1.1	-2.0	-1.6	-1.7	-1.5	-1.5	-1.3	-1.2	-8.8	
Exchange rate depreciation [7]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	-0.1	-0.5	-2.4	1.9	-1.3	-0.4	-0.5	-0.1	0.0	-0.3	
Privatization Revenue (negative)	-0.3	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Increase in deposits and other (- means drawn down of deposits)	0.2	-0.3	-2.4	1.9	-1.3	-0.4	-0.5	-0.1	0.0	-0.3	
Residual, including asset changes [8]	2.4	-3.0	1.1	0.9	1.7	0.3	0.3	0.2	0.0	3.3	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Bond Spread over German Bonds.

4/ Defined as interest payments divided by debt stock at the end of previous year.

5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

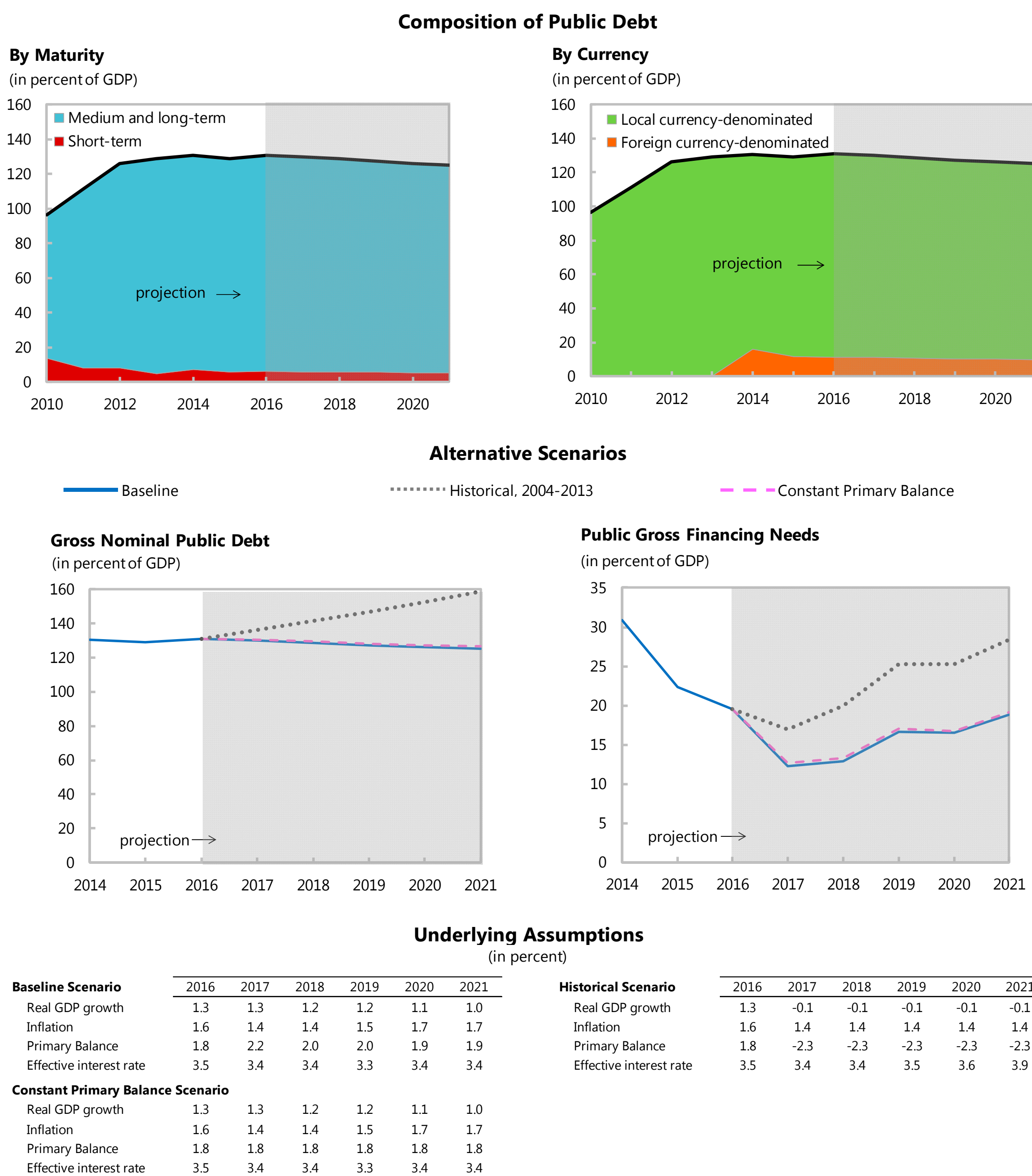
6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

8/ For projections, this line includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Figure 4. Portugal: Public DSA - Composition of Public Debt and Alternative Scenarios, 2010–2021



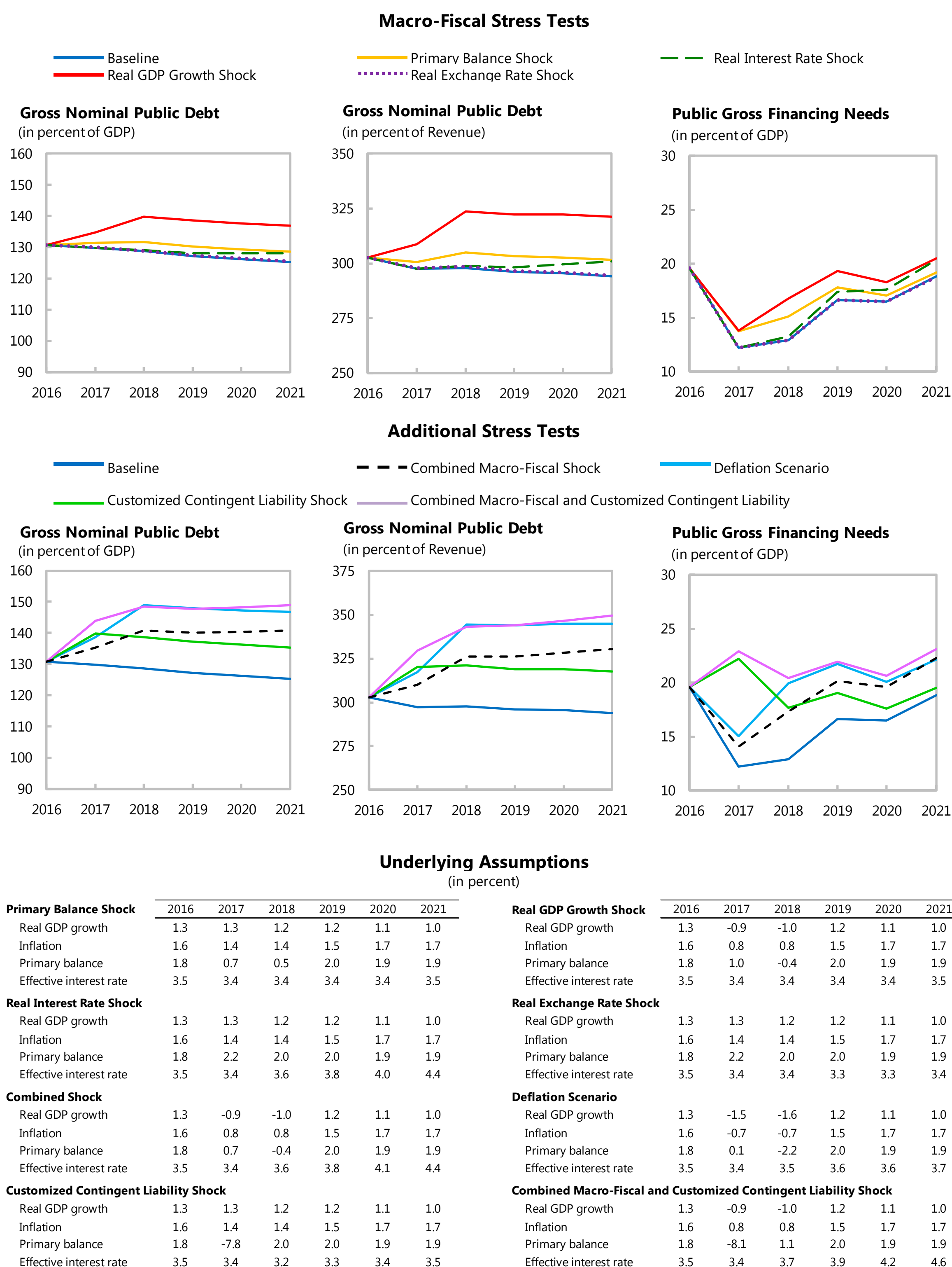
Underlying Assumptions
(in percent)

Baseline Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	1.3	1.3	1.2	1.2	1.1	1.0
Inflation	1.6	1.4	1.4	1.5	1.7	1.7
Primary Balance	1.8	2.2	2.0	2.0	1.9	1.9
Effective interest rate	3.5	3.4	3.4	3.3	3.4	3.4
Constant Primary Balance Scenario						
Real GDP growth	1.3	1.3	1.2	1.2	1.1	1.0
Inflation	1.6	1.4	1.4	1.5	1.7	1.7
Primary Balance	1.8	1.8	1.8	1.8	1.8	1.8
Effective interest rate	3.5	3.4	3.4	3.3	3.4	3.4

Historical Scenario	2016	2017	2018	2019	2020	2021
Real GDP growth	1.3	-0.1	-0.1	-0.1	-0.1	-0.1
Inflation	1.6	1.4	1.4	1.4	1.4	1.4
Primary Balance	1.8	-2.3	-2.3	-2.3	-2.3	-2.3
Effective interest rate	3.5	3.4	3.4	3.5	3.6	3.9

Source: IMF staff estimates.

Figure 5. Portugal: Public DSA - Stress Tests, 2016–2021



Underlying Assumptions
(in percent)

Primary Balance Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	1.3	1.3	1.2	1.2	1.1	1.0
Inflation	1.6	1.4	1.4	1.5	1.7	1.7
Primary balance	1.8	0.7	0.5	2.0	1.9	1.9
Effective interest rate	3.5	3.4	3.4	3.4	3.4	3.5
Real Interest Rate Shock						
Real GDP growth	1.3	1.3	1.2	1.2	1.1	1.0
Inflation	1.6	1.4	1.4	1.5	1.7	1.7
Primary balance	1.8	2.2	2.0	2.0	1.9	1.9
Effective interest rate	3.5	3.4	3.6	3.8	4.0	4.4
Combined Shock						
Real GDP growth	1.3	-0.9	-1.0	1.2	1.1	1.0
Inflation	1.6	0.8	0.8	1.5	1.7	1.7
Primary balance	1.8	0.7	-0.4	2.0	1.9	1.9
Effective interest rate	3.5	3.4	3.6	3.8	4.1	4.4
Customized Contingent Liability Shock						
Real GDP growth	1.3	1.3	1.2	1.2	1.1	1.0
Inflation	1.6	1.4	1.4	1.5	1.7	1.7
Primary balance	1.8	-7.8	2.0	2.0	1.9	1.9
Effective interest rate	3.5	3.4	3.2	3.3	3.4	3.5

Real GDP Growth Shock	2016	2017	2018	2019	2020	2021
Real GDP growth	1.3	-0.9	-1.0	1.2	1.1	1.0
Inflation	1.6	0.8	0.8	1.5	1.7	1.7
Primary balance	1.8	1.0	-0.4	2.0	1.9	1.9
Effective interest rate	3.5	3.4	3.4	3.4	3.4	3.5
Real Exchange Rate Shock						
Real GDP growth	1.3	1.3	1.2	1.2	1.1	1.0
Inflation	1.6	1.4	1.4	1.5	1.7	1.7
Primary balance	1.8	2.2	2.0	2.0	1.9	1.9
Effective interest rate	3.5	3.4	3.4	3.3	3.3	3.4
Deflation Scenario						
Real GDP growth	1.3	-1.5	-1.6	1.2	1.1	1.0
Inflation	1.6	-0.7	-0.7	1.5	1.7	1.7
Primary balance	1.8	0.1	-2.2	2.0	1.9	1.9
Effective interest rate	3.5	3.4	3.5	3.6	3.6	3.7
Combined Macro-Fiscal and Customized Contingent Liability Shock						
Real GDP growth	1.3	-0.9	-1.0	1.2	1.1	1.0
Inflation	1.6	0.8	0.8	1.5	1.7	1.7
Primary balance	1.8	-8.1	1.1	2.0	1.9	1.9
Effective interest rate	3.5	3.4	3.7	3.9	4.2	4.6

Source: IMF staff estimates.

Annex II. Risk Assessment Matrix[1/]

Source of Risks	Relative Likelihood	Impact	Policy response
Loss of investor confidence due to reform reversals or other negative surprises potentially including difficulties in the banking sector or loss of sole investment-grade rating: • Increase in sovereign bonds yields and reduction in foreign direct investment. • Tighter ECB policies, including a reduction in asset purchases	**High**	**High** Significant funding distress higher public and private borrowing costs.	**To minimize exposure:** Strengthen policy buffers and avoid backtracking on reforms. **If risk materializes:** Take steps to restore market access at favorable terms and ensure banks' access to liquidity is maintained. Take fiscal measures to ensure fiscal targets are being met.
Financial distress in one or more banks, requiring intervention.	**Medium**	**High** Loss of confidence in the banking system, resulting in potentially high fiscal costs.	**To minimize exposure:** Proactive bank supervision to ensure balance sheet clean-up, a build-up of capital buffers in banks and of fiscal buffers. Strengthen oversight of banks' risk management practices. **If risk materializes:** Shore up the banks using the existing toolkit, while ensuring public debt dynamics are not compromised.

[1/] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Source of Risks	Relative Likelihood	Impact	Policy response
Economic fallout from political fragmentation: • **Protracted uncertainty associated with negotiating post-Brexit arrangements** could weigh on confidence and investment more than expected—most prominently in the UK and the rest of Europe with possible knock-on effects elsewhere. Increased barriers could also dampen the longer-run economic performance of affected countries more than expected.	Medium	Medium Portugal exports 3 percent of its GDP to the UK, the fourth most among Portuguese export destinations but below average across EA economies. UK tourists account for the largest share of tourist receipts from foreigners (more than 17 percent in 2015).	**If risk materializes:** UK and EA institutions should work collaboratively towards a smooth and predictable transition. ECB policy actions rein in financial volatility risk. Renewed structural reform effort to expand exports to other markets.
Tighter and more volatile global financial conditions: • **Sharp rise in risk premia with flight to safety:** Investors withdraw from specific risk asset classes as they reassess underlying economic and financial risks in large economies, or respond to unanticipated Fed tightening, and increases in U.S. term premia, with poor market liquidity amplifying volatility. Safe haven currencies—especially the US dollar—surge creates balance sheet strains for FX debtors.	Medium	High Given its high corporate and private debt levels, Portugal would be highly susceptible to financial contagion. The result would be a heightened financial stress in the Portuguese banking system, as balance sheet fragilities in both banking and corporate sectors are still significant.	**To minimize exposure:** Shore up liquidity and capital buffers; encourage private savings, and shrink private sector balance sheets. **If risk materializes:** ECB policy actions to ensure market liquidity, encourage lending to productive investment opportunities, and ensure orderly monetary transmission mechanisms, including expansion of asset purchase programs.

Source of Risks	Relative Likelihood	Impact	Policy response
Weaker-than-expected global growth: • **Structurally weak growth in key advanced and emerging economies:** Weak demand, low productivity growth, and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to lower medium-term path of potential growth (the Euro area, Japan, and the United States) and exacerbating legacy financial imbalances especially among banks (the Euro area) (high likelihood). Tighter financial conditions and insufficient reforms undermine medium-term growth in emerging markets (medium likelihood).	**High (US, euro area, and Japan)** **Medium (Emerging Markets)**	**High** Low growth would imperil debt dynamics in all sectors, with the euro area accounting for 60 percent of total exports putting the current account balance and IIP at risk.	**To minimize exposure:** Step up structural reforms to improve competitiveness and reduce debt overhang. **If risk materializes:** Accelerate and deepen domestic structural reforms.
Persistently lower energy prices, triggered by supply factors reversing more gradually than expected.	**High**	**Medium** A low fuel import bill is potentially offset by greater difficulties in Angola, a key economic and financial partner.	**To minimize exposure:** Step up efforts to clean up corporate balance sheets, including the reduction of exposures to Angola. **If risk materializes:** Shore up the banks using the existing toolkit, while ensuring public debt dynamics are not compromised. Renewed structural reform effort to expand exports to other markets.

Statement by Mr. Carlo Cottarelli, Executive Director for Portugal and Ms. Ines Lopes, Advisor to the Executive Director
February 17, 2017

I. Overview

We thank staff for the report of the fifth Post-Program Monitoring (PPM) discussions. The exchange of views that took place during the visit is very welcome, but it is our authorities' assessment that the progresses achieved in the economic, fiscal, financial and structural fronts are not fully recognized in the report.

The Portuguese Government reiterates its firm commitment to design and implement economic and fiscal policies that promote sustained and inclusive growth, in a context of fiscal consolidation. Those policies are focused on the recovery of households' and firms' incomes, by reducing the fiscal burden and improving labor market conditions; on the capitalization of firms, allowing them to invest, generate jobs and grow; and on addressing the remaining challenges of the financial system, critical also for the recovery of investment.

Developments and concrete results in all these areas were visible in 2016 and efforts in this direction will be further pursued in 2017.

For the Portuguese Government, strengthening the financial sector has been a priority. The staff report could have better recognized and evaluated actions undertaken in this area.

Legislative updates allowed for the strengthening of banks, which reinforced capital levels and stabilized shareholders' structures (discussed in section III).

Moreover, it is also our authorities' view that their strong commitment to promote a growth-friendly fiscal consolidation strategy is downplayed, at a time when its accomplishments are evident, most notably in the simultaneous breakthroughs on the fiscal and the employment fronts. The Government strategy is paying-off as evidenced by steady employment growth, unemployment close to single digits, stabilization of the financial system, and the lowest budget deficit in 40 years. The 2017 State Budget, approved in November, will continue on this path, ensuring a sustainable fiscal consolidation.

Finally, the structural bottlenecks of the Portuguese economy are being steadily addressed. It is also the Government's view that these efforts are not duly recognized in the staff's assessment. The ambitious reform agenda set out in the 2016 National Reforms Program, which was praised by the European Commission (EC), is being swiftly implemented, strengthening the reform momentum.

The combination of policy actions is allowing the economy to move to a higher and sustained growth path, with improved labor market developments and steady competitiveness gains. In 2016, GDP increased by 1.4 percent according to INE and the public deficit is expected to be

clearly below 2.3 percent of GDP, under the EC target of 2.5 percent and the revised national target of 2.4 percent. The fiscal outturn did not depend on any extraordinary measure; it is rather the result of judicious policies put forward during the entire year. Moreover, the primary surplus is expected to be above 2 percent. These results are significantly better than those forecasted by the Fund staff, which, in its September report, envisaged a GDP growth of 1 percent, a 3 percent budget deficit and a 1.6 percent primary surplus. Going forward, in 2017 the Government expects GDP growth to accelerate to 1.5 percent, with a 3.1 percent increase in investment, further consolidating the recovery. This is a conservative scenario as can be seen from the recent EC Winter Forecast for Portugal, which revised upwards Portugal's growth projection to 1.6 percent, from 1.2 percent in the Autumn Forecast.

II. Recent developments and outlook

The Portuguese economy is now on a sustained higher growth path. In the 3rd and 4th quarters of 2016, Portugal registered one of the highest GDP growth rates of the euro area, with a strengthened contribution from net external demand in the third quarter and investment in the fourth quarter. According to the balance of payments statistics from Banco de Portugal, the balance of goods and services continued to firmly improve and recorded an increase of €938 million up to November, with respect to the same period in 2015, due to improvements in both the balance of goods and the balance of services. The unemployment rate stood at 10.5 percent in the 4th quarter of 2016, 1.7 percentage points below the figure for the same period in 2015. Investment is also showing positive signs: private entrepreneurial investment rose 7.7 percent in the 3rd quarter of 2016, imports of equipment goods increased 8.5 percent in the 3th quarter of 2016 and heavy and light commercial vehicles sales expanded 12 percent in the second semester of 2016. Consumer confidence indicators are at a 17 year high.

This strategy will continue in 2017, with policies to reduce indebtedness of households and firms, promote investment and foster social cohesion. The Portuguese Government expects labor productivity to improve by 0.5 percent and unemployment is expected to improve over the 10.3% target envisaged in the 2017 State Budget. The Government is committed to continue to deliver strong reform impetus through the implementation of the National Reform Program (discussed in section V). The competitiveness of the Portuguese economy will continue to be at the top of the Government's agenda.

III. Financial sector

The Portuguese banking system went through a deep adjustment process that started in 2010, in anticipation of the Economic and Financial Assistance Program (EFAP), impacting size and composition of balance sheets, solvency and cost structures. Despite the

progress achieved, the banking system still faces several significant challenges, also vis-à-vis the European regulatory and institutional background. In particular, profitability remains subdued on the back of significant challenges concerning non-performing loans (NPLs) and cost cutting amidst low interest rates, weak economic growth and uncertainty on the contribution of Portuguese banks' international activity.

Positive developments should also be highlighted. The large reduction in the loan-to-deposit ratio (from a peak of 165 percent to 102 percent in June 2016) decreased banks' vulnerability to shocks in market sentiment. This trend has been persistent and is a sign of confidence in the banking system. Reliance on Eurosystem financing also continued to decline in 2016.

Returning to adequate levels of profitability remains a key challenge. In the first half of 2016, profitability remained subdued and reverted from non-recurring levels observed at the end of 2015. Net interest income continued to recover, on account of lower deposit interest rates, while income from financial operations, by nature less recurring, declined. The flow of impairments continued to weigh significantly on profitability. The reduction in administrative costs in 2015 due to restructuring efforts continued in 2016. Notwithstanding, the cost-to-income ratio increased year-on-year on account of a decline in operating profits.

Despite a clear medium term improvement, capital ratios fell marginally in the first half of 2016, as a result of the aforementioned weak profitability and the gradual elimination of transitional provisions for eligibility of own funds, as foreseen in CRDIV/CRR. The Portuguese banking sector still presented a lower CET 1 ratio than its European peers at the end of the first quarter of 2016, but continues to compare very well in what concerns the leverage ratio.

Against this background, further adjustment efforts are warranted, as banks need to proceed reshaping operating structures, outlets and distribution networks, also taking into account the challenges and opportunities of digital banking. Still subdued economic growth, very low nominal interest rates and low inflation rates challenge banks' business models in Portugal and other EU countries.

Finding adequate solutions to the high stock of non-productive assets, most notably NPLs of non-financial corporations, remains of paramount importance. Non-productive assets have been hampering banks' profitability and negatively affecting markets' perception of banks resilience. The systemic nature of the persistently high levels of NPLs, the need for a comprehensive approach and the European dimension of the problem (also related with potential spillover effects) recommend a European approach. This is a priority followed so far. Notwithstanding, at national level, the comprehensive and coordinated approach must be continued, involving all relevant stakeholders, in the various fronts: intrusive banking supervision; structural reforms in the legal/judicial/tax framework; and the promotion of a portfolio oriented NPL management, which may include a more systemic approach also dependent on the EU regulatory context (notably State Aid and BRRD).

The financing of companies with better risk profiles remains a key feature of the adjustment of the non-financial corporations' sector. In addition, the reduction of the share of the construction sector, particularly impacted by the economic crisis, and the increase of manufacturing and trade in banks' loan book continued. The profitability ratios in the latter two sectors exceed the average of the non-financial corporation sector. Although loans by the resident financial sector to non-financial corporations continued to decline, total corporate debt has slightly increased. This was associated to loans granted by non-residents to Portuguese companies, both by companies of the same economic group and by non-resident banks. Finally, credit granted to exporting companies has been growing at more favorable rates than the average. Households' stock of credit for house purchase continued the deleveraging path initiated in 2011, while credit for consumption and other purposes has been accelerating and showing positive growth rates since the second half of 2015. These latest developments are being closely followed by Banco de Portugal, as national macro- prudential authority, despite not being considered a source of significant risk in the short run.

It should be highlighted that strengthening the financial sector has been the priority of the Portuguese Government. The policy and legislative decisions aimed at strengthening banks' capital and promoting mechanisms that facilitate the recovery process of NPLs are bearing fruit. This strategy will continue to be pursued in 2017.

A number of key measures has already been implemented in 2016 thanks to the approval of legislation and political action. This allowed for a reduction of uncertainty in the banking system, particularly relevant to stakeholders. As such, the main private banks were able to stabilize their shareholders' structure and raise capital; the selling process of Novo Banco was re-launched, in a context of reinforced capital ratios, attracting several bidders; the stock of DTAs was stabilized and the remaining procedural aspects clarified; the maturity of the loan granted by the State to the Resolution Fund was extended and the interest payments reduced, eliminating uncertainty for the banking sector, and the ongoing capitalization of Portugal's biggest bank, Caixa Geral de Depósitos (CGD), thanks to the approval of the business plan by the EC, in a landmark decision recognizing the non-state aid nature of the investment.

IV. Fiscal policy

The strong commitment by the Portuguese Government to promote a growth-friendly fiscal consolidation is reflected in the fiscal results of 2016: budget execution data indicates that the deficit will be clearly below 2.3 percent of GDP and the primary surplus above 2.0 percent of GDP. This result was achieved due to a rigorous implementation of the budget and favorable developments on both the revenue and the expenditure side, which include *inter alia* cost savings and better Social Security revenues. According to the EC Winter Forecast

the Portuguese primary government surplus is foreseen to have been, in 2016, the third largest in the euro area.

The 2016 budgetary outturns shall allow Portugal to exit the Excessive Deficit Procedure with a secure margin of safety. The Government is committed to continue these efforts in 2017, having in mind the Medium Term Objective set forth by the EC.

The State Budget for 2017, approved on November 29, promotes a sustained fiscal consolidation, fostering private investment and reinforcing the recovery of households' income, fully in line with the Government program and with international commitments. To achieve these goals, the envisaged strategy focuses on five main pillars, namely (i) strict control of public expenditure, with the continuation of the spending review started in 2016 (focusing, initially, on health, education and public procurement, including SOEs); (ii) promotion of investment by creating incentives for firm capitalization and job creation; (iii) fiscal stability and fight against fraud and tax evasion; (iv) public administration reform; (v) support for the measures envisaged in the National Reforms Program (discussed in the next section).

In this context, the Portuguese Government expects the public deficit to maintain its downward trajectory in 2017, decreasing to 1.6 percent of GDP, and the primary surplus to increase further, reaching 2.8 percent. The weight of public expenditure on GDP is expected to be reduced in 2017, as is the fiscal burden. Public investment is forecasted to improve, reaching 2.2 percent of GDP in 2017.

In 2016, the general government debt-to-GDP ratio stood close to 130 percent, mainly due to the prefunding of the financing needs for CGD recapitalization that will occur in 2017 (€2.7 billion). However, the public debt excluding central administration deposits (net debt) has already declined in 2016 as a percentage of GDP, with the cash-buffer amounting to €10.2 billion at the end of the year (€6.6 billion in 2015). After a period of stabilization, the debt- to-GDP ratio will decrease in 2017, on the back of the primary surplus and of accelerating economic growth.

V. Structural Reforms

The Portuguese Government reiterates its commitment to address the remaining structural bottlenecks of the Portuguese economy. The National Reforms Program (NRP), published in end-March 2016, sets an ambitious reform agenda, with a well-defined calendar and goals, and was also based on the Country Specific Recommendations presented by the EC to Portugal. The NRP was welcomed by the EC, which considered that it showed sufficient ambition to tackle the excessive imbalances faced by the Portuguese economy.

The strategy outlined in the NRP, allows for an overarching, broad-based approach aimed at addressing (a) the historical skill's deficit of the population; (b) the medium-low innovative

character of the economy; (c) the modernization of the public sector, including simplification of administrative and licensing procedures for enterprises and the reduction of red tape costs;

(d) the high levels of public and private debt, which constrain the investment perspectives for the Government, firms and households; and (e) the need to ensure social cohesion and equality as key features for a sustainable economic growth. Amongst these priorities a special mention is needed to the first objective, which will be object of a National Skills Strategy supported by the OECD. This is key to enhance the medium- to long-term potential growth.

The implementation of the envisaged measures is being closely followed by the Government, with states of play being published every six-months (the first assessment was released in September 2016). From the total of 139 measures proposed, 2/3 were concluded or put in place in 2016 and, for the remaining 1/3, 78% were already launched or are ongoing.

The elimination of structural bottlenecks in the Portuguese economy has been advancing steadily. While the full materialization of the benefits stemming from reforms is only possible in the longer run, the ambition of the Portuguese reform agenda is already showing positive signs, with improvements in many of the structural indexes reported by institutions such as the World Bank, the World Economic Forum or the OECD. A very good example is the recently released OECD's Program for International Student Assessment results, where Portugal registered one of the largest improvements and is now above the OECD average in all indicators.

Overall, confidence indicators have been boosted, export capacity has been robustly strengthened, investment is expected to recover and unemployment, in particular youth unemployment, should continue on a downward path.

VI. Conclusion

The Portuguese authorities are fully confident that their obligations towards the Fund will continue to be timely met, and reiterate their strong commitment to uphold such obligations. The Government is also committed to a strategy that promotes sustained and inclusive growth, in a context of growth-friendly fiscal consolidation. The positive fiscal and economic results of 2016 support the maintenance of these efforts in 2017. Both the strategy envisaged in the 2017 State Budget and the ambitious National Reforms Program will decisively contribute to further consolidate the recovery.

The Portuguese authorities look forward to the sixth PPM mission, which will again constitute a good opportunity to closely work with the Fund, deepening our dialogue and promoting a broader mutual understanding.